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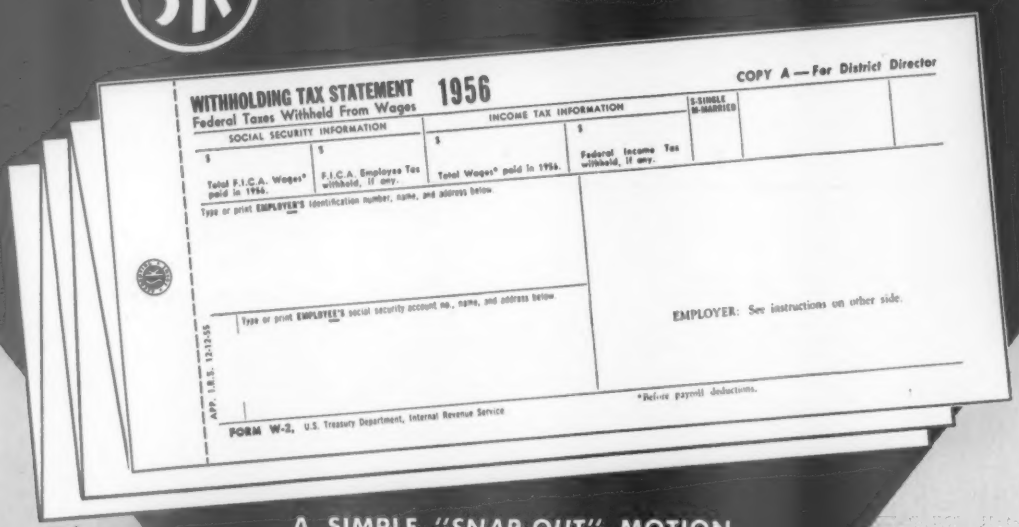

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28 of Treasury's famous secret loopholes and hardships revealed by Ways & Means Committee

For months now the tax fraternity has been aware that the Treasury had a list of loopholes in the law that it considered too hot to release, for fear of encouraging taxpayers to flock to use these tax-saving devices. Now, preparatory to hearings by the Subcommittee on Internal Revenue Taxation, Representative Mills makes public 28 of these unintended loopholes and tax hardships. Here is how the Treasury describes these notorious items.

SEVERAL of the unintended tax hardships and benefits uncovered by the Treasury were carried over from the 1939 Code. These include the following.

Oil production payments

A practice has developed under which the owners of oil or mineral properties sometimes carve out and sell a portion of their future right to oil or other mineral production, such as the right to receive the first $50,000 realized from the production of oil, or the right to receive the first 10,000 barrels of oil. Recent court decisions have held that the sale of a production payment carved out of any interest which the taxpayer has in an oil well is eligible for capital gain treatment. Also, it has been held that a taxpayer who gave a mineral payment to a charity was entitled to a charitable deduction for the value of the payment and at the same time could exclude the mineral income from his taxable income.

It is suggested that the proceeds received from the sale of oil and other mineral production payments by persons who carve them out of larger interests be treated as ordinary income from the production of minerals. In the case of donations of carved-out production payments adjustments would be made to prevent double benefits; that is, the benefit both of an exclusion from income and a charitable deduction.

It is suggested that the subcommittee may also want to examine various other arrangements by which interests in oil and other mineral sold after the taxpayer has previously disposed of operating interests in mineral production.

The subcommittee may want to consider making these provisions effective with respect to transactions entered into after the date of this report.

Amortization of premiums on tax-exempt bonds held by dealers

Under the present law where tax-exempt State and local government bonds are purchased at a premium, the premium generally must be amortized over the life of the bond and, in effect, offset against the tax-exempt interest income. Exceptions are provided to this general rule for dealers in tax-exempt securities with respect to bonds disposed of within 30 days, and bonds with a maturity or call date more than 5 years from the time they were acquired. Since amortization of the premium is not required by a dealer under these circumstances, he realizes an ordinary loss upon sale or redemption of bonds disposed of within 30 days, or for bonds maturing more than 5 years from his date of acquisition. This loss, which may be offset against taxable income, is attributable to the interest payments the taxpayer is not required to include in his taxable income.

It is suggested that these 30-day and 5-year rules be removed with the result that dealers in tax-exempt bonds will be treated the same as other holders of tax-exempt bonds. This might be made effective with respect to bonds purchased after the date of this report.

Transfers of installment obligations to controlled insurance companies

The taxation of gain on installment obligations is ordinarily deferred until the collection or other disposition of the obligations. However, under present law the installment obligations in certain cases may be transferred without tax consequences to the transferor, as for example in the case of a distribution in liquidation of the transferor in the manner provided in section 453(d)(4), or they may be transferred to a controlled subsidiary company in exchange for stock or securities in the manner provided in section 351(a). A similar problem may be presented in the case of a contribution to capital. Ordinarily in these cases the transferee reports the remaining income, but where the transferee is a life-insurance company the profit element on the installment obligations is free of tax since it would constitute a type of gain which is not taxable to life insurance companies.

It is suggested that transfers of installment obligations to controlled life insurance companies made after the date of this report be denied status as tax-free transfers.

Use of intercorporate dividends—received credit in connection with purchases and sales of stock around dividend dates

At the present time corporations sometimes buy stock just before a dividend is payable with a view to receiving dividend income. Then immediately after the date on which the dividend becomes payable the stock is sold. The selling price usually will be less than the purchase price by approximately the amount of the dividend, so that there will be a deductible loss equal to the dividend income. In this case the corporation can obtain a tax saving because 15 per cent of the dividend is taxed to the corporation, reducing the 52 per cent rate to 7.8 per cent, while at the same time the corresponding loss is deductible against income taxable at 52 per cent in the case of corporate security dealers, or deductible against income taxable at 25 per cent in the case of non-dealers.

A similar problem exists where stock is sold short and at about the same time

identical stock is purchased. In such cases the dividends received are eligible for the 85 per cent corporate dividends deduction. The payment to cover the dividends on the short position represents investment expense deductible against income taxable at regular corporate rates.

It is suggested that these problems can be dealt with by appropriate adjustments to the amount of the dividends subject to the 85 per cent corporate dividend deduction or in the basis of the stock sold in such a transaction. The rule could be applied to stock held for a period of not more than 10 days which includes the dividend date. In the case of dividends paid on preferred stock this holding period could be extended to not more than 90 days if the dividends have accrued for more than 1 year. These changes could be made effective with respect to purchases of stock made after the date of this report.

Transactions in regulated investment company shares around time of distributing capital gain dividends

Under present law a regulated investment company is not taxed on any net long-term capital gain which it distributes. Instead, the dividend is treated as a long-term capital gain by the stockholder. Dealers in securities have purchased the stock of regulated investment companies for inventory just before one of these capital gain dividends was payable. Then immediately after receipt of the dividend, the stock is sold. The selling price of the stock in this case will usually be less than the purchase price by approximately the amount of the dividend. A loss of this type, in the case of a dealer in securities will be an ordinary loss deductible against ordinary income even though the income distribution is a capital gain dividend taxable in effect at a maximum rate of 25 per cent. Somewhat similar situations exist where purchases and sales of regulated investment company stock around capital gain dividend dates are made by taxpayers other than dealers (or by dealers with respect to investment accounts). The income received is a long-term capital gain, the loss on the sale of the stock is a short-term capital loss which can be offset against any short-term capital gains the taxpayer may have, which otherwise would be taxed as ordinary income.

It is suggested in the case of purchases and sales of regulated investment company stock around capital gain dividend dates that long-term capital loss treatment be required with respect to losses on the sale of the stock. This change could be made effective with respect to all acquisitions of regulated investment company stock after the date of this report.

Use of short sales to postpone recognition of capital gain

Under present law it is possible for a taxpayer by the use of short sales to terminate his risk in the stock market, withdraw a substantial portion of his funds, and yet postpone for an extended period of time any realization of capital gain. A taxpayer who has held for more than 6 months a number of shares of stock which has appreciated in value may sell short the same number of shares of this stock. By depositing with his broker the stock he already holds, the taxpayer can obtain from the broker a substantial portion of the proceeds from the short sale. The taxpayer in this case is almost as well off as if he had sold his stock outright since he has terminated any further risk in the market. However, until he orders the delivery of his stock to cover the short sale, no capital gain is realized for tax purposes.

The Treasury suggests that the subcommittee consider denying the unreasonable postponement of capital gains tax where a taxpayer sells stock short when he already holds shares of the same security. Any action taken might be made effective with respect to short sales occurring after the date of this report.

Improvements on property subject to renewable leases

Generally, taxpayers are required to spread the recovery of the cost of a property over its useful life. However, taxpayers constructing buildings or other improvements on leased property amortize the cost of the improvements over the life of the lease where this is shorter than the life of the improvements. This generally is true even if the lease is renewable at the option of the lessee and the cost of the improvements would otherwise be recovered by the lessee over the life of the improvements. A similar shortening of the recovery period exists where the lessee and the lessor are related or subject to common control whether or not there is an option to renew the lease and whether or not the lease is in fact renewed.

It is suggested that the amortization period for the improvements made by a lessee should include any period over which the lessee has the right to renew the lease (but not longer than the life of the improvement). Where the lease is not renewed any unrecovered cost would then be deductible in the same manner as an abandonment loss.

In the case of improvements made by lessees who are related to the lessors, or subject to common control, the cost of the improvements could be spread over the life of the improvements. In this situation where a lease is not renewed, any unrecovered cost might be available for recovery by the property owner through depreciation. It is suggested that related taxpayers for this purpose include ancestors, spouse, and lineal descendants, controlled corporations and partnerships, and related estates and trusts. Control might be defined to mean ownership of 80 per cent or more. These changes could be made effective with respect to deductions taken in taxable years beginning after December 31, 1956.

Prepaid interest and charitable contributions

Under present law a cash-basis taxpayer may deduct the full amount of prepaid interest at the time of the prepayment. A double deduction may occur where interest on a loan secured by a property is prepaid and then the property is donated to charity. In such cases the taxpayer may take both a deduction for the prepayment of interest and a charitable-contribution deduction for the property given to charity. The charitable-contribution deduction reflects not only the value of the property less the indebtedness, but also the prepayment of the interest, or the amount for which an interest deduction already has been taken.

It is suggested that where a taxpayer has deducted prepaid interest and subsequently makes a gift to charity of property securing the loan for which the interest deduction was taken, the taxpayer be required in the year of the gift to make an adjustment in his income (or possibly in the charitable-contribution deduction) for any interest attributable to a period after the gift to charity. This change could be effective with respect to gifts made after that date of this report.

Deduction of interest payments while receiving charitable deductions for related interest income

Under present law it is possible for a taxpayer to borrow money to purchase a bond (or other form of indebtedness) and then donate the bond (or other indebtedness) to charity just prior to any date on which an interest payment could be received, and in this manner may obtain the benefit of both an interest deduction and a charitable deduction with respect to what in effect is the same amount. An interest deduction is available for the interest paid on the loan. The interest income on the bond, which corresponds to the interest payment on the loan, is, however, not payable prior to the donation of the property to the charity and thus is not included in the income of the taxpayer. Moreover, the charitable contribution deduction in this case, which is the fair market value of the property donated (less any indebtedness), reflects the return which will shortly be paid on the bond (or other form of indebtedness).

It is suggested that where funds are borrowed to purchase a bond or other form of indebtedness which in turn is donated to charity, any interest deduction with respect to the loan should be allowed only to the extent it exceeds any interest income attributable to the same period which is received by the charity from the donation. This change could be made effective with respect to donations to charity after the date of this report.

Deductions rather than exclusions for income earned abroad

Present law provides an exclusion from United States tax for income earned abroad in the case of United States citizens who are bona fide residents of a foreign country and an exclusion of up to $20,000 a year for United States citizens who are abroad for 17 out of 18 months. Because an "exclusion," as distinct from a "deduction," is provided for the above types of income, it not only is free of tax but also need not be reported for tax purposes even though a citizen is otherwise required to file a return. However, some citizens mistakenly assume the exclusion applies no matter how short a time they are abroad. In addition other forms of income of United States citizens who are abroad are subject to United States tax (although with a credit for foreign taxes in the case of income derived abroad). This includes investment income, income from a taxpayer's business to the extent it is attributable to capital and not personal efforts, income from personal services rendered in United States, and income from personal services rendered in a foreign country to the extent it is in excess of $20,000 in the case of a citizen abroad for 17 out of 18 months but not a bona fide foreign resident. In all of these cases, in addition to some tax evasion, there is confusion among taxpayers as to whether the exclusion is applicable. Moreover, where taxpayers believe the exclusion to be applicable, they report no information relative to the income, which means that the Internal Revenue Service does not have an adequate basis of information to determine whether the exclusion is properly applied.

The Treasury suggests that the subcommittee consider converting the present "exclusions" for income earned abroad into "deductions" in computing adjusted gross income. This could require reporting in the case of all United States citizens abroad whose gross income, including all earned income, amounts to $600 or more. This change, if made, would not deprive United States citizens of the tax-exempt benefits received from "exclusions" under present law. The change from an "exclusion" to a "deduction" might be made with respect to taxable years beginning after December 31, 1956.

Depreciation on heavily mortgaged property

Under present law the basis of property for purposes of depreciation, as well as gain or loss upon sale, takes into account any mortgage on the property at the time of acquisition. In the usual case the value of the property at the time of its purchase is accurately reflected by this rule which takes into account not only the purchase price but also the obligation which the buyer incurs. However, cases have arisen where mortgages were placed on property and then subsequently the value of the property has fallen below the amount of the mortgage (as, for example, in areas where a basic industry has moved or gone into a decline). In such cases persons have purchased the property subject to these very large mortgages without assuming personal liability for such mortgages. The depreciation allowed in these cases is based not only on the cash paid for the properties but also on the much larger amounts of the mortgages, even though the taxpayers may have no intention of making any payments on the mortgage.

It is suggested that where at the time of the purchase of a property its fair market value is appreciably less than the amount of a mortgage on the property, and no personal liability is assumed for the mortgage by the taxpayer, the depreciation allowable on the property should be limited to the amount actually invested. A similar rule could be applied where a corporation is created merely to take title to the property and it assumes personal liability. This change could be made effective with respect to depreciation allowances for taxable years beginning after December 31, 1956.

Compensation paid largely in annuity contracts by certain tax-exempt organizations

Present law provides that an annuity purchased by an employer under a plan which qualifies as nondiscriminatory under standards set up in the tax laws and also any annuity purchased by an exempt educational, charitable, or religious organization for its employees is to be taxable to the employee when he receives annuity payments after retirement, and not when the employer pays for the annuity. In some instances educational organizations have been known to pay selected employees all, or almost all, of their compensation in the form of an annuity. Usually these are part-time employees of the educational organization who derive their principal income from other employment, and want the annuity, rather than money, as a means of deferring tax on funds they intend to save in any case.

It is suggested that the blanket tax deferment for annuities given to employees by educational, charitable, and religious organizations be available only in the case of those organizations which pay no more than 10 per cent of the compensation of any employee in the form of an annuity contract. A special rule could be provided for contributions for past service of employees which would permit contributions of an amount up to 10 per cent of amounts paid for past service (or 10 per cent of the present wage rate times the period of past employment). As under present law annuities paid by tax-exempt educational, charitable, and religious or-

ganizations could still qualify where annuities in excess of 10 percent of total compensation were paid if the pension plan of the organization met the regular nondiscrimination requirements of existing law. The changes suggested here might be made effective with respect to premiums paid on annuity contracts in taxable years beginning after December 31, 1956.

Original issue preferred stock with a high redemption price

Original issue redeemable preferred stock (with a high redemption price) is issued at a price less than the redemption price. In some cases such stock may be sold, subject to capital gain rates, to a third party immediately prior to redemption. In addition, some redemptions of this preferred stock may qualify for capital gains treatment.

The Treasury suggests that gain on sale or redemption of preferred stock, where there is a large disparity between issue and redemption price, be treated as ordinary income. This change might be made applicable with respect to sales or redemptions of such original issue preferred stock after the date of this report.

Sale of life interests

Under present law where by gift, bequest, or inheritance a life interest in property is given to one person and the remainder interest to another, the basis for the property is shared by the life tenant and remainderman. In the case of a gift the combined basis of the life tenant and remainderman is the basis of the donor; in the case of a bequest or inheritance their combined basis is the fair market value of the property at the date of the decedent's death (or the optional valuation date). In both cases the life tenant's share of this basis is in the ratio of the value of his interest to the total value of the property. Since a life tenant's share in the value of property is determined by his life expectancy, his share of the basis of the property keeps decreasing and finally expires upon his death. Conversely, the basis of the remainderman for his interest keeps increasing until he has the full basis (minus any depreciation taken) at the time of the life tenant's death.

Present law provides that the life tenant may not amortize his basis over the period he is expected to have the use of the property (although in the case of depreciable property he may take depreciation during this period). However, the life tenant, can achieve much the same result by selling his life interest. In this case his basis at the time of the sale is taken into account in determining any taxable capital gain. Moreover, where the life tenant sells his interest to the remainderman, the remainderman can amortize his cost against the income from the property and still have full basis for the property (less any depreciation taken) upon the death of the life tenant.

Multiple trusts

With certain limited exceptions under present law trust income which is accumulated is taxable to the trust and not the ultimate beneficiaries. The trusts in these cases are subject to the regular individual income tax rates and for the most part are treated the same for tax purposes as individuals, although their "personal exemption" is limited to $100. Cases have arisen where an individual in order to avoid the effect of higher individual income-tax brackets has set up several, instead of one, accumulation trusts for gifts in trust to the same individual.

It is suggested that solutions to this problem be examined by the subcommittee in connection with the study, now in progress, of the tax treatment of estates and trusts. The staffs suggest that the subcommittee open the hearings, however, to those desiring to testify on this subject.

Foreign investment companies

Some foreign countries have provided especially low tax rates for investment companies having nonresident stockholders in order to attract investment funds to their countries. Canada, for example, provides that investment companies, incorporated in Canada, at least 95 per cent of the value of the stock of which is held by nonresidents and which meet certain other requirements are to be subject to a maximum tax of 15 per cent as contrasted to the general corporate rate in Canada of 45 per cent. Investment companies with United States stockholders have organized in foreign countries under laws of this type, have registered with the Securities and Exchange Commission in order to sell securities in this country, and follow the announced policy of paying little or no dividends and plowing back the dividend and other income they receive into additional investments. In these cases the only taxes applicable are the capital-gains tax paid to the United States upon the sale of the investment company stock by the United States stockholders, and the nominal corporate tax paid to the foreign government. If such companies were incorporated under United States laws, they would be treated in one of two ways. Either they would be required to distribute most of their earnings currently as regulated investment companies, in which case the ordinary individual income tax would be applicable, or the regular corporate income tax would be applicable with the additional risk that the accumulated earning tax might be applied.

1954 Code items

Several of the Treasury's loopholes and benefits arose in the 1954 Code. The following items, says the Treasury, require further study.

Detached coupon bonds

Where a bond is sold with a number of interest coupons detached a discount is created. This discount decreases as the due dates for these interest payments pass, with resultant increases in the value of the bond. Prior to the enactment of the 1954 Code it was contended that when the bond was sold or redeemed the gain, although in the nature of interest income, should be treated as a capital gain.

The 1954 Code stopped this possible conversion of ordinary income into capital-gain income except where the detached coupons were due within 12 months of the bond purchase date. This was accomplished by treating as ordinary income, on sale or redemption of the bond, any gain to the extent it represented income attributable to the fact that coupons were detached at the time the bond was purchased.

It is suggested that this ordinary income treatment be extended to all bonds from which coupons have been detached even though the coupons are due within less than 12 months. This change might be made applicable to all acquisitions after the date of the release of this report.

Amortization of premiums on bonds with call dates

Prior to the 1954 Code premiums on bonds generally were amortized over the period from date of acquisition to maturity or an earlier call date. This

permitted taxpayers to write the premium off against ordinary income, then in the event the bonds were not called the bonds could be sold at a premium subject to capital-gains tax only. This process might, for example, be repeated indefinitely as long as the premium existed, by groups buying and selling the same bonds to each other.

The 1954 Code disallowed the fast writeoff for certain bonds with a call date more than 3 years from the date of issue of the bonds. However, taxpayers can accomplish the same result as before the enactment of the 1954 Code by using bonds with call dates slightly more than 3 years from date of issue, and by using these bonds in this manner after they are 3 years old.

It is suggested that taxpayers be required in all cases to amortize premiums over the period to maturity. The unrecovered premium should then be deductible as an ordinary loss where bonds are called prior to maturity (or where a bond is sold after a call has been definitely announced).

The 1954 Code provision was effective with respect to bonds issued after January 22, 1951. The Treasury Department suggests that the subcommittee consider making the new provision effective with respect to future purchases of callable bonds regardless of when issued.

Discount bonds

Under the 1939 Code it was contended that any gain on a discount bond realized upon the maturity of the bond as a result of the excess of the amount received upon retirement over the issue price was treated as a capital gain. The 1954 Code made it clear that original issue discount is to be spread over the entire period to the maturity of the bond and treated as ordinary income. However, if the bonds are sold or retired prior to maturity any original discount, previously not reported as ordinary income, might be a capital gain. A practice appears to have developed of issuing bonds with an artificially large discount and calling these original issue discount bonds at par before their maturity date. As a result, the difference between the issue price and the call price is claimed as a deduction against ordinary income by the corporation while the bondholder claims capital-gains treatment on the unamortized discount.

It is suggested that where bonds (or other indebtedness) with original issue discount are redeemed before maturity, or sold prior to maturity, that any original issue discount not previously reported as income, be treated as ordinary income in the year of the sale or redemption. This change might be made effective with respect to sales or redemptions occurring after the date of this report.

Interest deductions for loans on annuities and life insurance policies

Under present law interest expense on an indebtedness incurred or continued (directly or indirectly) to purchase a single premium life insurance, endowment or annuity contract is not deductible. Moreover, a life insurance, endowment, or annuity contract is considered a single-premium contract if substantially all of the premiums are paid wihin 4 years from the date the contract was purchased, or if an amount is deposited with the insurer for the payment of a substantial number of future premiums on the contract. However, other plans have been developed whereby the endowment feature, as distinct from the term insurance feature, of a life-insurance policy has in effect been borrowed back. This is accomplished by borrowing the increment in the cash surrender value of the policy each year in order to pay premiums then due. Additional funds usually must also be borrowed either from the insurer or a bank. In such cases taxpayers are obtaining the benefit of the interest deduction with respect to the funds borrowed and also the benefit of the accumulation in the insurance company reserves of tax-free interest income.

The Treasury suggests that the subcommittee consider means of eliminating this special advantage. One approach would be to disallow as a deduction any amount paid or accrued on indebtedness incurred or continued to purchase or carry a life-insurance, endowment, or annuity policy, if the policy was purchased in pursuance of a plan of premium payments or premium settlements which contemplated that a substantial number of premiums would be paid by means of such indebtedness. Under this approach, the new treatment might be made applicable with respect to interest deductions on loans incurred after the date of this report.

Variable price restricted stock options

Under certain conditions present law provides "restricted stock option" treatment for "variable price" options, i.e., under certain conditions gain resulting from the exercise of these options need not be reported until the sale of the stock obtained under the option and is treated as capital gain. "Variable price" options qualify only if (in addition to other requirements) the only variable in the purchase price under these options is the value of the stock within a 6-month period which includes the date the option is exercised and if the option price would have been at least 85 per cent of the value of the stock at the time the option is granted if exercised at that time. However, under this provision variable price options have been granted where a "lookback" is used whereby the price of the option is determined by applying a percentage to a stock price during a past period which is still within the 6-month period. Where the price of the stock has fallen by any considerable amount this makes it possible to grant an option at a much lower percentage of the price at the time of the option than intended, and such an option could hardly be considered an incentive option. For example, if stock has fallen from $150 to $100 per share in a 2-month period, an option then granted at 56.7 per cent of the price with a 2-month "lookback" would meet the 85 per cent test at the time of the granting of the option (since 56.7 per cent of $150, the price 2 months earlier, would be about $85, or 85 per cent of the $100 stock value at the time of the granting of the option). However, if the price of the stock remains at $100 for the next 2 months and the option is then exercised, the price is only $56.70 (since 56.7 per cent of the price 2 months earlier was $56.70).

It is suggested that no "lookback" to a period prior to the date the option is granted be permitted, in determining the stock price for variable price options, except the average price of stock in the 30 days preceding the granting of the option. This change could be made effective with respect to options granted after the date of this report.

Subsistence allowances received by police

Present law provides an exclusion from gross income, not to exceed $5 a day, for subsistence allowances for police officials of State and local governments. This was originally designed to provide for the special expenses incurred by

police because of the travel required as a part of their work. However, since the adoption of this provision, amounts, which in fact constitute ordinary salary, have been designated as subsistence allowances in order to obtain the benefits of this exclusion.

It is suggested that the law be amended to provide that, for taxable years beginning after December 31, 1956, the exclusion is to be available only in the case of amounts designated as police subsistence allowances on or before August 16, 1954, the effective date of the 1954 Code.

Deductions rather than exclusions for scholarship and fellowship grants

The exclusions for scholarship and fellowship grants under present law are available only in the case of scholarship grants of regularly established schools or colleges or fellowship grants. In the case of candidates for degrees exclusions are not available with respect to amounts received for part-time teaching, research, or similar employment. In the case of those who are not candidates for degrees the grantor of the scholarship or fellowship must be a tax-exempt educational, charitable, or religious organization or a governmental unit and the excluded amount may not exceed $300 a month for more than 36 months. It is believed that individuals, many because they do not know the rules described above, are failing to report scholarship or fellowship income not properly excluded from income. The Internal Revenue Service, because excluded income does not have to be reported, has no adequate basis to determine whether the statutory limitations and conditions have been met in these cases.

It is suggested that the present exclusion for fellowship and scholarship income be converted into a deduction in arriving at adjusted gross income. This will still permit taxpayers having qualifying scholarship or fellowship income to deduct these amounts and also use the 10 per cent standard deduction with respect to other income. This change could be made effective with respect to taxable years beginning after December 31, 1956.

Aggregation of oil and property interests

Section 614 of the 1954 Code permits a taxpayer owning interests in natural resources to aggregate his interests into one property where they form part of an opening unit. Thus, the combined properties are considered as one property for purposes of computing depletion, gain or loss on sale, etc. The application of these aggregation rules to oil and gas interests has created both hardships and benefits which were not contemplated at the time of their enactment. At the time of their enactment in the 1954 Code they were intended generally to cover problems peculiar to the mining industry. The fact that taxpayers are compelled to make elections under these provisions prior to production has created difficulties in the oil and gas industry. On the other hand, under aggregation rules, taxpayers are apparently able to combine oil and gas wells having low operating costs with those having high operating costs and thus obtain a greater percentage depletion deduction than is possible under the 1939 Code. This results by reason of the fact that the income and expenses from all the oil wells on the aggregated property are combined in applying the 50 per cent taxable income limitation on the percentage depletion deduction.

It is suggested that the subcommittee consider amending the aggregation of property rules so that they apply in a more limited manner in the case of oil and gas interests.

Short-term charitable trusts

Under present law taxpayers may use short-term (as short as 2 years) charitable trusts, for the benefit of hospitals, schools, and churches, to make contributions to these organizations. Where such trusts are used the 30 per cent limitation on the charitable deduction is inapplicable.

The Treasury suggests the elimination of the present special 2-year rule for such short-term charitable trusts. Thus, the general 10-year rule would apply to all charitable trusts, requiring a grantor to divert his income to charity for a period of at least 10 years in order to obtain an exclusion for this income. This change might be made applicable with respect to trusts created after the date of this report.

Premium payments test on life-insurance policies

Before the enactment of the 1954 Code life-insurance proceeds were included in decedents' estates to the extent they had paid the premiums, even though they had given away all the incidents of ownership in the policies before death. This premium-payment test was removed in 1954.

The Treasury suggests the inclusion in a decedent's estate of the difference between the proceeds received upon death and the reserve at the time of death or possibly the cash-surrender value at the time of death. This might be made applicable with respect to estates of decedents dying after the date of enactment of the bill in which this provision is incorporated.

"Prohibited transactions" of exempt organizations

Present law enumerates "prohibited transactions" which certain tax-exempt organizations, including employees' pension trusts, may not engage in without loss of exemption. Among these is the provision that a tax-exempt trust may not loan any part of its income or corpus to its grantor without the receipt of adequate security and a reasonable rate of interest. In many instances this has resulted in hardships to pension trusts by preventing purchases of a heretofore traditional type of investment such as unsecured debentures of an employer corporation which many do not regard as a loan.

The staff of the Joint Committee suggests that the subcommittee may want to consider the permissible types of investments that qualified pension and profit-sharing trusts can make.

Public comment invited

When Chairman Mills released this list, he stressed that the suggested solutions are designed to elicit public comment, that they do not necessarily represent the subcommittee's view, and that the list is not exhaustive. He also invited the public to utilize the hearings beginning November 19 to present other hardships and loopholes. ☆

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TAX PLANNING AND

Business management

EDITED BY CHARLES S. LOWRIMORE, Sr., CPA

Controlling income at the year end to minimize taxes – suggestions for planning

THE AWFUL SENSE of finality that settles over the completed taxing period when the final decisions have been made very often prompts the tax man to give the whole picture one last final look. After all the planning that has been done, are any tax-saving possibilities still unexploited? Two areas particularly are both fertile and worrisome: timing and management of capital v. ordinary, short v. long-term gain and loss.

We thought it might be useful to gather together a few paragraphs touching on the items that are most often considered in this kind of year-end planning. Not that these aren't pretty well known to most tax men. But as a reminder and easy check of the technical details, we offer the following brief notes.

It doesn't do any harm to restate at the outset the basic proposition: You can to some extent control the amount of net taxable income in the current taxable year by deferring the receipt of cash or its equivalent until after the end of the taxable year, or by accelerating collections in cash or its equivalent if you wish to accomplish an opposite result. The same is true with respect to control over deductions—pay all you owe to get more deductions and even go ahead with planned work making payments in this taxable year rather than in the next; if the opposite result is desired hold up all cash payments until the next taxable year.

The shifting of income and deductions of the accrual method taxpayer is accomplished by acceleration of shipping and billing to increase income for the taxable year, or by delaying shipments and billing to decrease income for a taxable year. The same is true with respect to the incurring of deductible expenses. The work can be completed and billed in the taxable year or it can be deferred until the succeeding taxable year.

Methods of deferring taxable income which are available to both the cash and the accrual basis taxpayer relate to sale of property and the use of the deferred payment method and the installment method. Under the deferred-payment method the reporting of the profit on a sale is deferred until after the full cost or basis is recovered, and under the installment method the profit is reported in each year, as collections are made, using the ratio of such collections to the total sales price.

Installments & deferred payments

But beware. Under the deferred payment method, the seller of the property must not receive notes which are negotiable in the ordinary course of commerce, nor mortgages. In other words the promise which the seller receives is nothing more than the word of the purchaser to pay the obligation, or in some cases a contract of sale. The deferment of the taxable income to the time when cost or basis is recovered is based on the theory that the promise to pay has no marketable value. This is sometimes applied to junior mortgages of doubtful value.

Under the installment method, the deferment of the profit is in the ratio of the uncollected balance of the notes or mortgages which do have a value; however, this installment method is available only if the seller has received 30% or less from the purchaser in the taxable year of the sale, even though the entire balance of 70% is paid in the succeeding year.

Deferred profits to offset losses

Deferred or installment-method profits can be used this year to offset losses. Assume that the taxpayer has incurred a substantial loss, either as an ordinary operating loss or as a capital loss in the taxable year. This loss can be offset by the gain from the deferred profit, by accepting evidences of debt, which have value, in exchange for the promise to pay which had no value, and in this way reporting the entire profit in the taxable year to offset the losses.

With respect to the unpaid balance on the installment sale, if the entire balance is collected in the taxable year, of course the entire amount of the deferred profit must be reported in the year the balance is collected. But this can be controlled by a partial collection or an exchange of evidences of debt or securities.

Capital gains and losses—individuals

One always considers selling property with an appreciated value to produce gains and selling property with a decreased value to produce losses. If you have accumulated capital losses, and the carryover time is running out, you might sell property at a gain to offset such losses, repurchasing the identical property immediately at the appreciated value, with a stepped up basis. The "wash rule" does not apply to the repurchase of property which was sold at a gain. If you have substantial gains on sale of property, consider selling other property in which there is a loss to offset the gains and eliminate the tax. However, you could not take the loss if you repurchased the same property within 30 days of its sale.

Short vs. long-term gains and losses

If there is a net short-term capital gain (holding period less than six months) such gain is taxed at ordinary rates; if there is a net short-term capital loss it is deductible in full. If there is a net long-term capital gain (over six months) it is divided by two for computing the ordinary gross income of an individual, and if a net long-term capital loss it is deductible from ordinary gross income to the extent of taxable income before exemptions, or $1,000, whichever is smaller. In any event the deduction of net long-term capital loss from ordinary gross income in any one taxable year is limited to $1,000. If there is an unused net long-term capital loss in any taxable year, such loss may be carried forward for a period of five years, using any part or the entire amount in any of the five successive

years as an offset to capital gains in such taxable years. Or if there is no capital gains against which the loss may be offset, then $1,000 each year may be used as a deduction from ordinary income, until any amount not in excess of $5,000 is used up in that manner. If there are short-term and long-term transactions in the same taxable year they are taken into account at 100% of value of gains or losses. For example: Taxpayer has a long-term gain of $10,000 and a long-term loss of $5,000. This is a net long-term gain of $5,000. And a short-term loss of $6,000 and a short-term gain of $3,000, result in a net short-term loss of $3,000. The net short-term loss is deducted from the net long-term gain leaving a net capital gain of $2,000. The amount to include in the gross income of the taxpayer is $1,000 or 50% of the net long-term capital gain.

Charitable contributions

You might review your contributions again, after estimating accurately your income for the taxable year. Check on the amount you are allowed to deduct for charitable contributions under your final income figure, keeping in mind that there is a difference in the percentage of allowance, with respect to churches, educational institutions and hospitals (30%) and all others (20%).

It may be that you would like to make a contribution in property, which has greatly appreciated in value. You can deduct on your income tax return the fair market value as of the date of the gift, regardless of the basis or cost to you. There is no taxable gain to you on the transfer of the property to the donee. The only time it is profitable to make a gift in property is when it has appreciated in value, never when it has depreciated.

Corporations—capital gains, losses

If a corporation has a net short-term capital gain in its taxable year the gain is taxed at regular corporate rates, 30% to 52%.

If the corporation has a net long-term capital gain the amount of the gain is taxed at a flat 25%, regardless of the corporate net taxable income.

If a corporation has both a short-term and a net long-term capital gain each is treated separately (as described above) on the tax return.

If a corporation suffers a loss on the sale of capital assets, in the taxable year, such loss is not deductible from ordinary income. But the loss may be carried forward for 5-years to be offset against any capital gains realized during the 5-year period.

Corporations—dividend payment

The closely held or family controlled corporation can decide when its shareholders must include dividends in their personal income tax returns, by declaring the dividend payable either in one year or the other. Careful consideration should be given to the now less severe penalty tax imposed for improper accumulation of earnings and profits.

You might have a corporation which can pay dividends in property rather than cash. This may be done by declaring the dividend in property, not measured by dollars, thus avoiding a corporate tax on the appreciated value of property. The shareholders receiving the property would report a dividend at the fair market value of such property, at the dividend distribution date.

Property as dividend

Of course, the corporation could distribute the property as a dividend to several persons, each having an undivided interest in the property in the ratio of their shareholdings.

Dividend distribution in property is only profitable when there is a current fair market value in excess of basis. If the property is worth less than basis, then sell it, realizing a loss, and distribute cash dividends.

Save estate taxes; pay with U. S. bonds

THE WISE PLANNER would do well to take a good look at today's bond market which offers an unusually good opportunity to save money on future estate taxes. According to the Treasury, there are many issues of U. S. bonds which can be turned in at par to pay estate taxes. Whether the bonds were bought below par is immaterial. They still pay the estate tax at their face value.

Many Government bonds are selling far below par today. If the estate planner buys enough of them now so that their face value will equal the estate liability, he in effect cuts down that liability. If the taxable estate is around $50,000, the saving will be about $500. If the estate is somewhere near one million dollars, the saving can be almost $20,000.

Of course, this type of advantage has to be weighed carefully against other investment opportunities. But while considering all the factors, it would be wise not to forget that when the bonds are redeemed at maturity, the gain the taxpayer receives is a capital gain. The bonds might therefore be a good investment both in terms of estate taxes and in lifetime planning. ☆

Borrowing from your employee-benefit trust; how to use your stock, maintain exemption

FEW EMPLOYERS can set up a trust for pension, profit sharing, or bonus plans without thinking long and seriously about the uses to which the accumulated money in the trust can be put. Here is good, liquid, cash, waiting to be put to use. If the employer needs working capital, or expansion money, it's difficult not to think in terms of taking advantage of your close family feeling to this money.

You can use this money, but you have to be very careful about how you do it, or you will lose your tax exemption. Note, first, these basic facts which show why the question is a complicated one.

Information returns are required

After the employer has established and qualified the trust there are certain rules that must be followed, during the life of the trust, to maintain its exempt status. IRC Section 6033 requires every trust, qualified under Section 401(a) to maintain adequate accounting records and file an annual information return. The records and the return will disclose gross income, expenses, receipts and disbursements. The Commissioner may require other information. The purpose of such records and returns is to enable the IRS examiners to determine whether or not the trust is operated in accordance with the Code and Regulations, with respect to taxable income under Section 502 and prohibited transactions under Section 503.

Under Section 502 an organization operated by the trust as a trade or business for profit is not an exempt organization. Under this rule such income or profit derived from such operation is

DEFINITION OF PROHIBITED TRANSACTIONS

SECTION 503(c) PROVIDES; "For purposes of this section, the term 'prohibited transaction' means any transaction in which an organization subject to the provisions of this section—

1. lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest, to;

2. pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;

3. makes any part of its services available on a preferential basis to;

4. makes any substantial purchase of securities or any other property, for more than an adequate consideration in money or money's worth, from;

5. sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

6. engages in any other transaction which results in a substantial diversion of its income or corpus to;

the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in Section 267(c)(4) of an individual who is the creator of such trust or who has made a substantial contribution to such organizations; or a corporation controlled by such creator or person through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation."

taxable, but it does not deprive the trust of its tax exempt status with respect to other income. Income from rental of real property or personal property if leased along with the real property is not considered as income or profit from a trade or business.

Prohibited transactions

Under Section 503(a) the exemption from income taxation may be denied to a trust, qualified under Section 401(a), if it has engaged in a prohibited transaction after March 1, 1954. However, if the trust did not enter into the prohibited transaction with the express purpose of diverting corpus or income from its exempt purpose or did not involve a substantial part of such corpus or income, the exemption will be denied only for the taxable years after or following the year in which the Commissioner has notified the trustee of the violation of the rules relating to engaging in a prohibited transaction. The notice, in my opinion, must specify the violation and give the particulars upon which the Commissioner has based the denial for exemption.

Reference is made to the "Definitions of Prohibited Transactions" under Section 503(c); the accompanying box shows six specifically defined transactions which are prohibited. However in this discussion only loans to the creator of the trust will be considered.

Loans to employer who created trust

When a loan is made, by the trust, to the employer who created the trust it is required that such loan be adequately secured and that the obligation carry a reasonable interest rate. The question arises as to what is adequate security, and what is a reasonable interest rate.

In my opinion, the requirements under Section 503(c)(1), for all purposes, are reasonable and sound. The employer who has initiated the plan and established the pension, profit-sharing or stock bonus trust for the exclusive benefit of employees and their beneficiaries, has under the qualifying rules effectively been divested of all incidents of ownership, rights and enjoyment of the funds contributed to the trust. Therefore, if there is a transaction between the trust and the creator of the trust it should be on a business basis and completed at arm's-length. The loan should be adequately secured in the same manner and under the same conditions as a similar loan would be secured if obtained from a stranger or from a banking institution. The interest charged should be the prevailing rate, in the area, which might be charged by a banking institution on the same class and type of loan.

Proposed regulations: adequate security

The proposed regulations as published in the Federal Register January 21, 1956 (volume 21 #14 (1.503(c)-1(b) on page 468) provide as follows:

"The term 'adequate security' means something in addition to and supporting a promise to pay, which is so pledged to the organization that it may be sold, foreclosed upon, or otherwise disposed of in default of repayment of the loan, the value and liquidity of which security is such that it may reasonably be anticipated that loss of principle or interest will not result from the loan. Mortgages or liens on property, accommodation endorsements of those financially capable of meeting the indebtedness, and stock or securities issued by corporations other than the borrower may constitute security for a loan to persons or organizations described in Section 503(c). Stock of a borrowing corporation and unsecured debentures of a borrower do not constitute adequate security."

Senate Finance Committee report

The Senate Finance Committee in its detailed discussions of the provisions of Section 503(c) had very little to say, and specifically said only:

"For example, if the trust loaned any part of its income or corpus to the employer-creator of the trust without the receipt of adequate security and a reasonable rate of interest, it would lose its exempt status.

"This section is substantially similar to Section 503 of the House Bill except for the application of this rule to stock bonus, profit-sharing and pension trusts that on March 1, 1954, held notes or other evidences of indebtedness representing loans made without adequate security or without a reasonable rate of interest."

In the discussion of the legislation no mention was made of the prohibition on stockholders of a corporation borrowing from a Section 401(a) trust. In my opinion, they were more concerned with the value of the security used as collateral to a trust fund loan.

Investments by trustees

The proposed regulations as published September 1, 1955, page 6457, as 1.401-1 (5)(i) states as follows: "No specific limitations are provided in Section 401(a) with respect to investments which may be made by the trustees of a trust qualifying under Section 401(a). Generally the contributions may be used by the trustees to purchase any investments permitted by the trust agreement to the extent allowed by local law." And, in part (ii) the regulations further provide: "Where the trust funds are invested in stock or securities of, or loaned

to, the employer or other persons described in Section 503(c), full disclosure must be made of the reasons for such arrangement and of the conditions under which such investments are made in order that a determination may be made whether the trust serves any purpose other than constituting part of a plan for the exclusive benefit of employees."

Investment in stock permitted

The stock of the employer corporation is acceptable as an investment of the employees' pension, profit-sharing or stock bonus trusts, in which case the trustee must pay out money. In making this investment, in the stock of the employer corporation, the trustee is charged with the same responsibility as if the investment was made in stock of some other corporation. It does not appear to be reasonable to say that the stock of the employer corporation is adequate as an investment of the trust but not adequate as collateral security for a loan made by the trust to the employer corporation.

Forfeiture of exempt status

Reference is made to the last sentence of the proposed regulations (published in the Federal Register of September 1, 1955 at page 6457, as Section 1.401-1(5)(i)), which reads as follows:

"Furthermore, the tax-exempt status of the trust will be forfeited if the investments made by the trustees constitute 'prohibited transactions' within the meaning of Section 503."

There is no prohibition in Section 503 with respect to investments in the stock of an employer corporation, unless as provided in subparagraphs (5) the trustee purchases securities or stock of a substantial amount for more than an adequate consideration in money or money's worth.

Under these circumstances if the employer corporation sells its stock to the trust it must be at a reasonable price closely approximating its fair market value. In this case the value would be established, and under the same circumstances it seems that such value would be reasonable for loan purposes.

Stock of borrowing corporation

There are two common situations where stock of an employer corporation might be available as collateral security for a loan: (1) treasury stock acquired by the corporation and held as such, and (2) stock of its shareholders who may be willing to loan their shares to the corporation for the purpose of securing a loan to the corporation. With respect to treasury stock it may have been acquired in a transaction in connection with payment of estate taxes, in which case a definite value would have been established.

Prohibition on using stock

It seems illogical and unreasonable that the Regulations would prohibit the use of the borrowing corporation's stock as adequate security for a loan from a Section 401(a) trust if such stock had ample value to secure the loan.

Here is a situation in which it might be found reasonable to recognize the borrowing corporation's stock as adequate security for a loan from the trust.

The employer corporation has established the employees' trust and has each year made its regular contributions thereto. It has its funds invested in receivables, inventories, plant and in treasury stock. It has an excellent credit rating and produces each year a substantial profit on its operations. The value of the employer-corporation's stock is unquestionably far in excess of the loan for which the stock is offered as security. The corporation finds that it needs $100,000 in cash for the purpose of redeeming capital stock with which to pay estate taxes on the estate of one of its deceased shareholders. Due to pressing cash needs in current operations it must borrow the $100,000; the trust has the funds available for investment and is willing to loan the money to the corporation at the local prevailing rate of interest. Here is a transaction which, in my opinion, would justify the loan with the stock as collateral for such loan, and would meet the tests with respect to a full disclosure of the reasons for the arrangement and the conditions under which the loan was made. ☆

Fast depreciation boosts machine installment sales

SOME OF THE BENEFITS that fast depreciation provides are demonstrated in the growth of a new installment sales market in the machine and tool industry. This development, of comparatively recent origin, is fast displacing the long-term leasing of machine and tool equipment or the large one-layout expenditure for their purchase.

NEW TAX LAWS

AN EXCELLENT short summary of all the new tax laws passed at the last session of Congress appears in *Internal Revenue Bulletin* 1956-41, October 8, page 87. It is recommended reading for those desiring a quick, authoritative picture of the many small amendments to the 1954 Code, and other new laws affecting taxation which have recently been passed.

This market is developing because the new installment plan is the hand which fits into the fast-depreciation glove. Payments are largest in the first years, smaller in the later years. On a ten-year plan, half is paid for after three years and three-quarters after five years. Each year, the purchaser pays approximately the same amount that he is deducting for depreciation. As a result, his deductions are greatest during the years of highest efficiency and least repairs, lowest in the years of lower efficiency and more repairs. That way the purchaser spreads out his deductions in a much more favorable way.

This new plan, which contrasts with the older five-year, five equal installment plans that were previously widely used, has proved to be of great use to industry. Purchasers, more willing to buy under these terms, can keep their equipment up to date. Manufacturers have increased their sales, and the lending organizations have found a new source of business.

For these reasons, your clients or your company may find it highly worthwhile to sell their products and buy their equipment by this method. At the least, it certainly bears looking into. ☆

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MANAGEMENT OF THE
Professional tax practice
AND PROFESSIONAL AFFAIRS OF LAWYERS & ACCOUNTANTS

Why a corporation's separate tax department is most efficient in controlling tax costs

by **ALAN L. GORNICK**

Management is becoming increasingly aware that planning and cost control are as necessary in the field of taxes as in purchasing, distribution and labor relations. To that end, many companies are revising their administrative organizations to include separate tax departments with top-level representation that has full knowledge of the company's operations. These departments efficiently control tax costs, give more knowledgeable advice on prospective action, and are prepared for all possible tax controversies which might possibly arise. This article is adapted from a paper written by Mr. Gornick for the Fifth Annual Tulane Tax Institute. He originally included a description of the operation of the Ford Motor Company's Office of Tax Affairs (of which he is director), but we have eliminated it in the interests of brevity. The complete paper is included, however, in the proceedings of that meeting published by Bobbs-Merrill.

THE PROBLEM OF controlling tax costs is fundamentally the same as instituting planning and controls over any of the other major items of the cost of doing business. To control the cost of purchasing materials and supplies, corporate purchasing activities have generally been centralized in a separate department. Similarly, to control the costs of labor, industrial relations or labor departments have been established in many corporations. Similarly, in recent years, we have been witnessing a spreading movement in corporate management for centralized and integrated control of a corporation's tax liabilities. The movement to which I refer is that which places in a single group, independent of other staff groups whose existence is more traditionally accepted, the responsibility for performing those services which relate to a corporation's taxes. The group is generally composed of both attorneys and accountants, and is directed by a person on the higher echelon of the management group who reports directly to top officials—typically, to the president or executive vice-president and, in the case of at least one company, to the board of directors.

Advantages of a separate department

It is possible, of course, to have a consolidated tax group which is a subordinate part of another unit, but several reasons indicate that a wholly separate roof is desirable for maximum effectiveness. First, the very complexity of tax laws renders it undesirable that management receive its advice from sources several times removed. As the advice is passed on through channels, and shorter summaries are prepared from longer summaries, the risk of distortion is heightened; persons who are generally conversant with taxation but are burdened with other responsibilities may fail to realize or to stress all the relevant considerations. A second reason which favors separateness is that the head of the group, by virtue of being present at top-level policy and planning conferences, is able to render advice before projects have started to crystallize. While the decision making is still in process, he can determine when the matters under consideration should be referred for a more detailed examination. To rely on a person whose familiarity with tax matters is derived primarily from an occasional hasty reading of the black-letter headlines, such as commercial services can provide, to detect the existence of a lurking tax problem is hardly the most satisfactory way of conducting complex business affairs. Some questions will not have been covered or even perceived; in other areas illusions of tax certainty will have been created where none in fact exists. In tax law, as elsewhere, a little learning can be a dangerous thing.

This second reason also indicates one of the advantages which a corporation having a specialized tax group enjoys over the one whose organizational setup may place principal or sole reliance upon outside advisors. The latter may be called in at a time when the bargain has been struck and it may be difficult, even if possible, to retrace the company's steps and start anew on a second approach. As a result, the corporation is often burdened with unnecessary tax costs. Moreover, management frequently finds it easier to discuss its problems with one who is not regarded as an "outsider"; closely related is the fact that the tax group contains individuals who have an accumulating factual familiarity with the problems of the corporation and can utilize time-saving shortcuts, unavailable to outside persons, to obtain the information which they lack. As a result, they can be confident that their conclusions represent a workable solution and are based upon the facts of the situation.

Another reason is simply that a greater number of vital problems receive appropriate attention. In a great number of instances, they would not be referred to outside consultants for review either through blissful ignorance that a problem exists, or through inertia, or through a desire to "keep down costs."

Organizing the tax department

Without attempting to discuss the question as to what types or sizes of corporations might safely do without a coordinated and centralized tax group, I would like to suggest that the type for which such a group is most necessary is that which has multistate activities and operates in foreign as well as domestic areas. There is, however, the practical question as to how such a tax

group may be instituted in the type of corporation just mentioned. If the company does not already have an independent tax group, the tax responsibilities are probably allocated among several existing groups. Suggestions to form a new group may be viewed with suspicion and hostility which normal pride of jurisdiction can create. It may be easier to create a separate group where the change is incident to an internal reorganization resulting from the assumption of control by a completely new set of managers. Changes such as this are, however, rather unusual. In a great number of instances, the change, if it takes place, will be the result of a realistic evaluation as to the dangerous inadequacies of decentralized corporate tax procedures followed by the decision, however painful, to rearrange personnel. The receipt of a completely unanticipated tax deficiency of unaccustomed size should be an unnecessary catalyst, but in some cases this unhappy inducement has been the motivating force.

Functions of tax department

The type of tax group which is the most effective in instituting tax planning and coordinating and controlling tax costs is, in brief, one which consists of attorneys, accountants, and on occasion engineers, under a single command which reports directly to top management. Similar to the responsibility placed in the Purchasing Department or the Labor Department, the responsibility of managing and administering all the tax affairs of the company should be charged to such a group.

Its functions should normally fall within the following four categories: (1) to advise all levels of management as to (a) the tax effects of prospective action, (b) possible tax economies which may be effected by changes in present setup or procedure, or otherwise, and (c) the effect on the company of the constant changes in tax law resulting from new administrative rulings, court decisions, and legislation, including the effect of proposed legislation; (2) to prepare, or approve before filing, all returns and other forms of information submitted to any taxing authority, and approve all tax payments; (3) to handle or review for the company all audits of tax returns and participate in all controversies with the taxing authorities; (4) to maintain complete and accurate records of all tax action by or affecting the company, including all adjustments between tax and book figures.

Advising on tax effects of plans

At every point of tangency between corporate activities and the tax laws, a few hours of prospective thinking can be more beneficial than any amount of retrospection. It would require little imagination to list virtually endless illustrations of this fact; much more imagination would be necessary to suggest any major corporate action where possible tax consequences could safely be ignored. The types of concrete problems and the nature of the necessary tax planning naturally vary according to the nature and size of the company. However, any launching of a new plant, any sale of real estate or equipment or other property, any exchange or merger or liquidation, any drafting of agreements with suppliers or distributors, any change in sales prices of the company's products, any modification of pension or retirement plans—all can be adequately considered only after an advance weighing of their Federal, and often local, tax implications.

For this reason, the function of giving tax advice to management is probably the most valuable service which an integrated tax group can and should perform. The same business result may frequently be reached by several methods, but one method may incur the maximum tax and another the minimum or, on some occasions, none at all. The difference between the two methods may be sufficient to turn what appears to be a profitable transaction into an unprofitable one. Accordingly, the importance of determining the tax effect of proposed action before the action is taken is obvious. Tax planning is not, of course, an end in itself, and many actions of the company which are advisable from a business standpoint will be taken even though they have unfavorable tax consequences. However, any business which proceeds without knowing the tax effects of its action is playing blindman's buff.

Planning of this nature before the event may perhaps be typically illustrated by the question which frequently arises as to the most advantageous tax situs (other factors being equal) for establishing a new plant. For example, the tax group may be advised that half a dozen alternative locations have been tentatively selected for the erection of a new manufacturing installation. In such a situation, surveys should be conducted by the tax group to compare effective tax costs. Applicable franchise, income, sales, use, unemployment, and ad valorem taxes must be pieced together into a composite comparison. Possible ad valorem taxes present a particular sort of difficulty in making such estimates; as a result, such surveys must be conducted not only when such possible sites are located in different jurisdictions, but also when various subdivisions within one particular state are involved.

Developing operating procedures

A tax group does not, of course, act in isolation. It must work closely with the company departments involved in the various problems. Operating procedures must, therefore, be developed to ensure that problems requiring tax analysis are submitted for timely review. At the same time, procedures are required so that instructions originating within the tax group on its own initiative may be brought to the attention of the appropriate departments.

As mentioned earlier, one of the advantages in having a tax group which reports to top management and whose head is in the upper echelon of the management group is that he is informed of major prospective actions. He can refer those questions which need serious review for more detailed consideration. Helpful general rules can also be formulated: for example, there may be a working rule that all transactions of a certain nature which come before the board of directors or an executive committee for consideration are to have concurrence or comments from the tax group. Obviously, however, such a rule would not cover the bulk of transactions and situations of which day-to-day operations are composed. Such routine, recurring problems lend themselves more readily to coverage by instructions prepared and sent directly by the tax group or published in various company manuals.

An organization of any size will frequently find it advisable to publish a tax manual in order to acquaint other departments of areas in which potential tax problems exist. Such a manual might also contain specific instructions which would cover the handling of routine items. Such instructions need not necessarily take the form of a single, separate publication, but relevant guides may conveniently be inserted in other

internal manuals which an organization may issue. One such manual in which a major part of the tax information would naturally be appropriate is the company's controller's manual. In a number of areas—for example, the proper method for accounting for fixed assets, the expensing or capitalizing of repair and betterment expenditures, or the withholding of tax on various wage payments—comments by the tax group would be required prior to publication. In other areas, the tax group would normally review each proposed instruction and submit its comments with a view toward facilitating audits and narrowing the many divergencies which unavoidably exist between ordinary book figures and tax figures. Other appropriate publications in which tax instructions might be included are purchase and sales manuals. For example, instructions concerning the handling of sales for export may be included in the company manual relating to sales procedures. By spotting the instructions in such a manner, the likelihood that they will actually be applied in daily practice is increased. The material must, of course, be constantly reviewed and changed to accord with current developments.

A large organization may also wish to have a specifically-designated person or persons in the finance or accounting group serve as a liaison between the tax group and such department. Requests for clarification of existing instructions, and instructions to cover novel factual situations, can then be channeled through such liaison to the appropriate accounting point. Conversely, inquiries by the tax group itself for necessary facts or figures from plant controllers or other accounting personnel may be submitted through the same medium. Inevitably, requests for tax advice are, nevertheless, frequently received directly rather than through such channels. Where the inquiry is one of general application, the liaison group should nevertheless be advised of the answer in order that other locations and departments may act consistently.

The referral of tax problems will increase as a result of the gradual and continuing process of tax education which takes place throughout the company. As the existence of the tax group becomes known through the services which it performs (private problems which do not relate to compensation received from the company are usually left to outside counsel), an increasing number of problems are referred to it. To a considerable extent, this tendency may be stimulated by the common management-training programs of many companies. In part, such a program is designed to acquaint trainees with the functions of the various company components; one of these, naturally, is the tax group. The extent to which the rank and file of personnel may, as a result, become tax alert is sometimes surprising. In numerous instances, proposals for administrative changes believed to involve possible tax benefits find their way into the "employee suggestion" box. Thus far, no tax panaceas have been forthcoming from this source, but perhaps the employees should have been awarded something simply for trying.

Searching for tax savings

The tax group on its own initiative may seek ways and means of lessening the tax burden. With Federal, state, and sometimes local income taxes, franchise taxes, property taxes, gross receipts taxes, sales and use taxes, social security taxes, manufacturers' excise taxes and the numerous other taxes of today, the opportunity for tax savings is very great indeed.[1]

For example, a typical common planning possibility exists in arranging procedures for handling an organization's sales. Situations may arise in which a company makes shipments to a particular state in which it does not have a sales office. The tax group might wish to keep a sharp eye on the time and place at which title to the goods is deemed to pass. Title passage at the point of destination might lead to the conclusion that the company is doing business in that jurisdiction, with the result of additional tax liabilities. A closely-related question concerns the location of a new plant or other installation. Would the construction of a warehouse in the state of destination cause otherwise-exempt sales to become subject to local taxation? Similarly, where sale or shipment is made in one state with destination in another, the same transaction may be taxed in both states. Timely planning and control may prevent such a needless loss of income.

The challenge to proper and appropriate tax planning is not limited to the domestic scene. In fact, if the company engages, or is preparing to engage, in foreign ventures, the pitfalls are increased, and at the same time the tax visibility is decreased, by the injection of the tax laws of one or more foreign countries. The company will have to consider whether it would fare better by conducting the operations through a branch, a domestic subsidiary, or a foreign subsidiary located either in the country where the operations are to take place or possibly in another foreign country. The chameleon nature of some types of foreign corporations makes it necessary to review carefully exactly what type of legal entity is under consideration. A choice of form which eventually proves adverse may be very difficult to undo. The decision will naturally be affected by the applicable rates of foreign taxes and by their nature, with reference to availability for tax-credit purposes.

An additional factor to be taken into account is the type of activities which would be conducted abroad; the decision might be different, for example, if the company is engaged in an extractive industry or anticipates initial losses. Other familiar questions would include whether it would be preferable to receive the foreign income in the form of dividends, royalties, or interest; and to the extent that interest is involved, whether the indebtedness should take the form of a security or simply an advance on opening account. If a company has been operating abroad and has acquired a complicated structure of foreign subsidiaries and sub-subsidiaries, it may be possible and desirable, in connection with utilization of foreign tax credits and other items, to collapse the pyramid and acquire direct ownership of the various foreign entities.

Tax controls

The benefits to be derived from responsible tax planning and tax controls are not limited to the tax-testing of proposed or current corporate actions, although this obviously constitutes an

[1] It should be noted in this connection that taxes today are a matter of considerable profit consequence to a corporation. Taxes are generally levied upon a tax base voluntarily submitted by the company which can be adjusted by competent analysis, planning and the application of judgment to provide, within the law and regulations, the greatest possible savings to the company. The importance of Federal income tax savings to the company may be more clearly realized when it is considered that other types of savings generally increase the company's income subject to taxation, while this is not true of Federal income tax savings. An income tax dollar saved is in the fullest sense a dollar earned. Assuming an effective 50% federal income tax rate plus a 3% average effective rate for state income taxes, the saving of a dollar in federal income taxes is the equivalent of saving about $2.11 in other costs. To state this another way, under the assumed rates, it takes about $2.11 of profit before federal and state income taxes to earn one dollar after such taxes.

extremely important function. There are also (1) the handling of tax returns and payments, and (2) the review of the mass of changing current developments and the formulation of administrative procedures to apply them, correctly and with a minimum of cost, throughout the daily operations of the company.

Supervision of tax returns and payments

The basic and routine work of a tax group is, of course, the preparation and audit of returns. There is no need to dwell upon this at great length. As to the preparation of the Federal income tax return, which is naturally one of the basic and most time-consuming tasks, standard procedures must be developed for collecting the necessary information from the various departments at specified dates. The fixed asset, repair expense, and other figures furnished by the controller's office must be fed into the work sheets at a certain time; information from subsidiaries and foreign locations must be assembled and placed on a uniform basis; and, more important than merely collecting figures, the most favorable sustainable position on possibly debatable items has to be determined and reduced to file memoranda.

Especially if there are multistate operations, the payment of local taxes should be reviewed by the central office, even if initially handled by local personnel. To the unpracticed eye, all local property assessments or other tax bills are surrounded with an aura of finality. If the company's rights are to be fully protected, prudence requires that a group with specialized experience should pass upon them. Even the checking of record title and of mathematics requires some organization. Once a local property tax bill, for example, is received in the office, it is necessary routine to check the rates and assessment to ensure that the bill was properly computed. A related point which might be mentioned is the desirable practice, where a company has widely-scattered properties, of promptly notifying the taxing authorities of all purchases and sales of real property, to make certain that all bills are at least properly addressed. This minimizes the chance, by no means impossible in a large organization, that taxes might continue to be paid automatically on property which the company no longer owns; it also ensures the prompt receipt of bills on property which the company has purchased, in order that unnecessary interest payments on delayed bills may be avoided. Such seemingly prosaic precautions can often yield liberal dividends.

It is, of course, highly important that the tax group early develop standard forms and the mechanics of gathering the basic figures and information from the corporate books and records. These forms and procedures are particularly necessary if the information comes from a number of departments or locations of one corporation or from the records of a number of corporate subsidiaries and affiliates where consolidated returns are used. These forms should be drawn to show in detail the conversion of book figures to tax figures. Such forms will vary to fit the particular type of business involved. However, they will assure uniform preparation and handling for each of the many sources from which such information is gathered.

Maintenance of records

Another basic service which a tax group can perform is to supervise the collection and retention of factual records and legal memoranda which are relevant in supporting the positions the company has taken in preparing and filing its returns. It is difficult to overstress the importance of this seemingly elementary point. During World War II, many of the older companies experienced considerable unnecessary difficulty with the excess profits tax simply because they lacked proper historical records. In a great number of instances, they no doubt paid far greater taxes than would have been required had adequate information been available. At audit time, possibly many years after the filing of the return, an inability to reconstruct a problem and produce supporting records will not only lead to the increased likelihood that the particular item under examination will be challenged; it can also serve to raise natural doubts in the auditing agent's mind about the accuracy of numerous other items which would otherwise have passed unquestioned.

Records also play an essential role in forward tax planning. It is one thing to proceed with a definite knowledge of facts. It is quite another to have nothing more than the realization that "it may be this, and then again, on another assumption, it may be that." It would, for example, be impossible to supervise an inventory-control program without periodic reports as to what property was situated where, and moving to which location, and at what time. Complete current records are, of course, essential backgrounds in compiling periodic tax accruals and forward tax estimates in appraising the company's financial position.

Reviewing current developments

It is unnecessary to belabor the advantages of having a specialized group review, with the company's particular problems in mind, the new developments in court decisions, statutes, and rulings. It is often possible, when there is an alert tax group in an organization, that impending rulings which would change the interpretation of existing laws may be discussed with Government officials in advance of issuance. Knowledge of such impending rulings can sometimes be obtained from the commercial services; perhaps more frequently, knowledge is forthcoming through a related business organization. In a recent case, it was learned for example, that the Internal Revenue Service was preparing to issue a ruling which in substance would have denied an excise tax exemption on certain articles which many companies purchase for export. A committee was organized; several members studied the legal sufficiency of the proposed Service position; others gave consideration to the economic implications and the possible effect upon the export trade. After various conferences, Government personnel were persuaded that the taxpayers' position was sound, and the exemption was continued.

The existence of a tax group working in conjunction with other corporate departments often makes it possible in such situations to make the Treasury aware of debatable points and of practical difficulties which may be inherent

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in proposed Regulations but which might otherwise be overlooked. Not too long ago, for example, proposed Regulations were published concerning income tax liability and withholding procedures with reference to sick pay. The possible effect upon a large company of such Regulations necessitated a review not only by tax personnel but also by various affected company groups on the industrial relations, insurance, and accounting staffs. It was apparent from such a review by many large organizations that compliance with certain requirements of the proposed Regulations might prove extremely burdensome and costly; in at least one respect, compliance would have been wholly impossible. Comments were filed with the Internal Revenue Service by many business, accounting and law groups. The Regulations which were issued in final form reflect an awareness of the administrative practicalities and have eased considerably the burdens which had been imposed. This type of corporate department activity may be mentioned as one of the real but not too-apparent advantages which result from having a tax group which is in active contact with other tax organizations and at the same time can present the company's particular problems under pending legislation or Regulations in an effective and appropriate way.

The magnitude of corporate taxes naturally compels frequent applications for specific Treasury rulings. Such rulings are sought not only in areas where, despite extensive research, the applicable rules of law are unclear (and only too often the lack of clarity increases with added research); they may also be desirable where there is relatively little present doubt of the correct tax principle but where the tax costs, if the transaction did sometime lead to the imposition of liability, would be catastrophic in amount.

Conclusion

It should be obvious that business reasons will sometimes exist for taking a path other than that of the least tax costs, but an organization which proceeds without clear knowledge of its probable tax costs, and without an effort to control them efficiently, will find itself seriously handicapped. The need for planning and cost control, long recognized as essential in other areas of a company's operations, is becoming evident in the area of taxation. To an increasing degree, modern management is becoming aware of the need for administrative reform in this field. This tendency should, I believe, be welcomed and appreciated by corporate taxpayers and taxing authorities alike. ☆

Tarleau urges no separate "tax profession"; basic law and accounting judgments needed

As TAX WORK assumes a larger share of the attention of lawyers and accountants, consideration is given with increasing frequency to the possibility that a separate profession of tax specialists should be established. This proposal is sometimes made in connection with disputes between lawyers and accountants over tax practice, and sometimes by those students of both professions who see the development of an identifiable separate profession as the logical evolution of present forces.

But much respectable opinion in the two professions look with some concern on this possibility. Thomas N. Tarleau, a partner in the New York law firm of Willkie, Owen, Farr, Gallagher and Walton, and a former head of the Section of Taxation of the American Bar Association, cautions strongly against the evils of a third profession of "tax specialists". He put his point well in remarks made at the recent annual meeting of the California Society of CPAs. Here is an excerpt containing the essence of his view:

"I've written a paper on the question of the relationship of tax law, so-called tax law, to general law. The idea that there is such a thing as tax practice—separate and apart from law and accounting—has always bothered me a great deal. It has bothered other members of my profession a great deal as well.

"I have discussed in this paper of mine, up until the last few pages, the question of the relationship of tax law to general law, and the necessity in doing legal work in the tax field to have a good lawyer, and the reasons why I believe you need a good lawyer. And then I go on to say:

"I have said nothing about what to many persons now appears to be the most urgent question in connection with the relationship of tax law to general law. That is, of course, the question of whether taxes should not be a third profession, to the practice of which we should admit specialists at least from the two fields of law and accounting. The ever-growing complexities of this commercial age have created a close relationship between lawyers and accountants in all fields, but nowhere is it closer or more important than in the field of federal taxes. Accounting questions impinge upon so many determinations required in the computation of federal taxes that no brief statement of the questions which accountants are called upon to answer in the tax field could properly summarize their role. A few examples, however, will indicate something of the difficulty and importance of the accountant's job in tax matters.

"Incidentally, I am writing this for lawyers to be published in a bar journal, and for that reason I am trying to tell you how we are trying to educate the lawyers about the role of accountants in tax practice.

"The determination of the period in which income is realized or expenses incurred is of course fundamental in the computation of income-tax liabilities. In making such determination, accountants are, among other things, charged with measuring what losses have occurred in particular periods from deterioration or obsolescence of inventories, determining how the exhaustion of productive facilities shall be allocated to particular periods in relation to the physical life of such facilities, and their economic usefulness for the production of goods, and the determination of when and how uncollected income shall be accrued, or the accrual of prepaid income deferred.

"These, of course, are only three examples from a particular area of the accountant's responsibility. Answering these questions both for income tax purposes as well as general accounting purposes in a complex enterprise, calls for the most expert and sophisticated accounting judgments. No suggestion can be made that the questions presented to accountants in income tax matters are in any way less difficult than the lawyers' problems. In answering them for tax purposes, the accountant's role parallels that of the lawyer in tax practice. He must call not only upon his special-

ized knowledge of tax accounting, but on his entire experience and knowledge as an accountant.

"Any controversy between lawyers and accountants as to who shall engage in the tax practice is a side issue. The real point is that the taxpayer with an accounting problem can only be served by a good accountant—one, if you will, with a competence in general accounting which matches the special expertness which he has in the field of tax accounting. To suggest that the taxpayer can best be served by a tax specialist gravely undervalues the importance, the complexity, and, above all, the breadth of the accounting problems which arise in connection with federal taxes. To go further and suggest that such a specialist, be he originally disciplined either as a lawyer or an accountant, should bear the entire burden in tax matters is doubly dangerous in so far as the interests of the taxpayer are concerned.

"There is no such thing as a separate practice of taxes. There is rather the practice of law and the practice of accounting with respect to tax problems. The problem is not the validation of a new specialty, but of bringing more good lawyers and more good accountants to work on tax problems for the benefit of both the taxpayer and the economy as a whole." ☆

Accountant gives workpapers to client; IRS can't subpoena them

SUPPOSE A TAXPAYER refuses to cooperate with the IRS in a tax investigation, says nothing, and makes no records available. Can the IRS get his accountant's workpapers? In a recent case, *Matter of House,* [5 JTAX 225], a California district court refused to enforce an IRS subpoena to produce these papers. The taxpayer had been farsighted enough to have previously asked the accountant for the workpapers. They thus became the taxpayer's property, and were protected by his right to avoid self-incrimination.

One comment by the judge is very noteworthy. He said that it was surprising that the taxpayer agreed with the Government's contention that only the legal owner of the documents may invoke the self-incrimination privilege. The implication may be that even if the accountant still had the papers the client could prevent their use.

Here's what District Judge Murphy had to say:

"This is a proceeding . . . to enforce a subpoena requiring the production of certain documents for examination by the Bureau of Internal Revenue . . .

"Irving S. Levy, Harry C. Levy, Barney B. Levy, and Helen Levy are the taxpayers in question. Taxpayers are partners in a clothing business. In 1953, the government began in investigation to determine whether there was a basis for an indictment of taxpayers on the criminal charge to tax evasion. Having learned of the investigation, taxpayers retained counsel, including Winters. Taxpayers have since 1945 employed, and continue to employ, an accountant named Wood in a variety of accounting capacities relating to the business and personal accounts of the partnership and the partners. In the course of such employment, Wood had received from the taxpayers a large quantity of files, records and other documents, which he retained in his offices. In the course of such employment, Wood has also prepared a number of working papers, consisting of abstracts, analyses, and other extracts or compilations relating to the documents given him from time to time by the taxpayers.

"Upon advice of counsel, taxpayers instructed Wood to turn over all documents, specifically including his working papers, relating to taxpayers, to taxpayers and their counsel. Taxpayers instructed their accountant to turn over certain files to themselves directly, and other files, including the working papers, to their counsel on their behalf. Wood did as he was instructed. He testified that he realized that he retained no further interest in the documents he turned over to taxpayers and their counsel, and that he could not get them back. From time to time after turning these documents over to taxpayers and their counsel in 1953, Wood was given access to them, in connection with work he was doing for taxpayers, but in each case, with the permission of counsel for taxpayers.

"The subpoena which is sought to be enforced in this preceeding was served on taxpayers' counsel, Winters, Harless and Faulkner, on April 6, 1956. It directed them to produce:

" 'All documents, records and files relating to the named taxpayers and their parents, received from Kenneth S. Wood, C. P. A., or any agent or employee of Mr. Wood, and particularly the 31 files received from Kenneth S. Wood, C. P. A., San Jose, California, on or about September 3rd or 4th, 1953, consisting of the accountant's work papers and other files relating to accounting work performed by Mr. Wood during the above named and prior period for the named taxpayers and their parents.'

"Winters and his associates appeared at the time and place named in the subpoena with all the papers in question, but they declined to turn over any of the papers, on three separate grounds: (1) That the statute of limitations on the collection of taxes with respect to the period to which some of these papers related had run, and that papers relating to such periods could therefore not be examined; (2) That the papers were entrusted to them within the attorney-client relationship, and they were therefore protected from disclosure under the attorney-client privilege of the law of evidence; (3) That they were invoking, on behalf of their clients, the privilege against self-incrimination guaranteed by the Fifth Amendment to the Constitution of the United States.

"This proceeding was thereupon instituted by the Government. At the hearing, the Government withdrew its request for all documents except the "working papers" of the accountant Wood. Those papers, therefore, are the only ones in question.

Attorney-client privilege irrelevant

"Taxpayers' contentions regarding the attorney-client privilege are so clearly unfounded that it is astonishing to find able counsel raising such arguments in their behalf. . . . It is entirely clear from the record that the attorneys now making this claim at all times knew that the documents at any time involved were either disclosed to the accountant Wood and his associates, or produced by Wood, *prior* to their delivery to counsel. Under such circumstances, it is obvious that no privileges can subsequently arise.

"Taxpayers' contentions regarding the

statute of limitations apparently rest upon 26 USC 7605 (b), which bars "unnecessary examination and investigations" in pursuance of the power granted to the government under 26 USC 7602. This limitation upon the Government's investigatory power is one of great importance to the privacy of the papers of taxpayers and potential taxpayers, as well as any person who may have had financial dealings with them. The courts have not as yet had much opportunity to give specific meaning to the general language of 26 USC 7605 (b). The test of a complaint by the Government which would entitle it to examine documents relating to periods earlier than those for which tax liability may be assessed at the time of examination would appear to be whether the complaint alleges with sufficient particularity the likelihood of fraud on the part of the person under investigation, so as to make inapplicable the statute of limitations. . . . It would appear . . . that where the Government seeks to examine documents relating to a period for which tax liability is ordinarily barred by the statute of limitations, the burden is on the Government to show why such examination is not unnecessary . . . The complaint alleges that the investigation of taxpayers' possible evasion of income taxes for the years 1950 to 1953, inclusive, was prompted by the discovery of a large sum of cash in a safe deposit box [in] 1951, and the deposits of cash totaling some $300,000 during the year 1950, all without a 'reasonable' explanation to representatives of the Internal Revenue Service. The complaint further states 'that in order to determine whether or not taxpayers have attempted to defeat and evade income taxes for years 1950 to 1953, inclusive, it is necessary and desirable that an investigation be made into the original cost of assets held by taxpayers at the beginning of the year 1950, and thereafter; the nature and kind of assets disposed of by taxpayers before 1950, which were, or which might have been, converted into assets which were held at the beginning of the year 1950, or thereafter; the amounts of cash or other assets received by taxpayers, the amounts of borrowings, gifts, bequests, or other non-taxable receipts, and other matters relating to years before and after 1950, which tend, or might tend, to bear upon the assets and liabilities of taxpayers at the beginning of the year 1950, and thereafter, and the nature and amounts of taxpayers' income and expense during the years 1950 to 1953, inclusive.'

". . . The Government alleges an investigation into attempts to 'evade' and 'defeat' taxes, which fairly connote fraud. It supports those allegations with a recital of facts which make it reasonable to investigate the possibility of fraud. The statute of limitations for civil actions is therefore no obstacle to the investigation here sought.

No illegal search

"In addition to the grounds of refusal mentioned above, taxpayers through their counsel, refused to turn over the documents to the Internal Revenue Service on the grounds that the government, in obtaining these documents by subpoena, would be conducting an illegal search and seizure, forbidden by the Fourth Amendment to the Constitution, and would be denying taxpayers the right to counsel guaranteed them by the Sixth Amendment to the Constitution. The contention under the Fourth Amendment is, for the purposes of this case, subsumed under the right against self-incrimination. If it is not self-incriminatory to require taxpayers to turn over these documents, it is difficult to see why it is an unreasonable search and seizure, provided the statutory procedure is observed. Counsel do not contend otherwise, and apparently treat the objections under the Fifth and Fourth Amendments as one.

"The contention under the Sixth Amendment seems to have been for good measure rather than for good reason. It was not seriously pressed at the hearing before the agent, it was not mentioned at the hearing in this court, and it is not supported by the briefs for taxpayers. Taxpayers have at all times had counsel. The Sixth Amendment bears no relation whatsoever to this case.

Must client personally claim privilege?

"The substantial question in this case is whether the Government is seeking an order for production of documents which would violate the taxpayers' privilege against self-incrimination as guaranteed by the Fifth Amendment to the Constitution.

"The Government attacks, first, the standing of the attorneys to invoke the privilege on behalf of their clients . . . The Government apparently seeks to establish a novel rule that unless the client himself participates in hearings such as the one held before the agent of the Internal Revenue Bureau, he waives his Constitutional rights. The Government could thus put any taxpayer to the choice of attending hearings or investigations, sometimes carried on over considerable periods of time, or waiving his privilege against self-incrimination. Such a rule would accomplish nothing except to impose a heavy penalty in terms of time and money on those taxpayers who chose to assert their right against self-incrimination under the Constitution. The effective exercise of Constitutional rights should not be abridged by any such technical and onerous requirements as that.

Does taxpayer own working papers?

"The next argument made by the Government relates to the fact that the working papers here involved were originally produced by the accountant. The Government claims that these working papers are the property of the accountant, and that therefore taxpayers may not avail themselves of the privilege with respect to those papers.

"This argument assumes that only the legal owner of documents may invoke the privilege against self-incrimination as a bar to requiring him to produce documents in his possession. Counsel for taxpayers, surprisingly, seem to have accepted this argument, and argue that the California statute, as applied to this case, makes taxpayers the legal owners of the documents.

"There is no contention by the Government that taxpayers or their attorneys are not in rightful, indefinite possession of the documents. This court has already found that the attorneys were holding the documents for the taxpayers and that their possession of them is the possession of taxpayers, for our purposes. The argument of the Government is therefore reduced to the proposition that the application of the privilege aganst self-incrimination turns on the difference between rightful indefinite possession and legal title. Nothing in the cases substantiates this notion that a narrow concept of property laws should determine the availability of Constitutional guarantees against self-incrimination . . .

". . . Even assuming that the California statute set out above would govern the point at issue, the property in these documents is clearly in the taxpayers. They directed Wood to turn

them over to themselves or their agents, and Wood did so, as he testified, with no intention of retention of any title, or belief that he could get them back. There is no dispute between accountant and client as to who owns the papers. The Government relies on the words "express agreement" in the statute, apparently reading it as "express contract" so as to require a contract satisfying the normal standards of an executory contract. There was an express direction by the taxpayers to the accountant to turn over the documents. The accountant complied. Whether this was a gift, a unilateral contract in which the terms were expressly stated by the taxpayers and performed by the accountant, or even an executory contract in which the taxpayers stated the express terms and offered as an implied consideration continued employment of the accountant, is a matter of academic dispute. It is clear enough that there was an express agreement between the accountant and the taxpayers that ownership in the papers should become vested in the taxpayers at the moment of transfer of the papers to the taxpayers' agents. Thus, even under the California statute, the papers are the property of the taxpayers.

Public records doctrine does not apply

The case at bar does not fall within the scope of the so-called public records exception to the privilege against self-incrimination . . . The papers involved in the case at bar are obviously not within the public records doctrine. They were not required to be kept by law, nor are they even regular business records of a business or organization subject to the state's power of inspection. They are no more than the private notes of an accountant, rightfully possessed and owned by the persons from whom the government now seeks to extract them, for use in a criminal proceeding against them. The Government has cited *Shapiro v. United States*, 335 U.S. 1 (1948). That case concerned records required to be kept by a valid Government regulation. It has no bearing on this case.

The zealous prosecution of violations of the criminal laws is the business of the Government. But the zealous protection of the liberties of the people should be equally the concern of the Government. The field of taxation represents probably the greatest single area of contact between individuals and the force of the state. A slight invasion of the right against self-incrimination in this field has as great and baleful consequences upon the relations between the individual and the state as does an invasion of that right in the more dramatic areas of public life.

The application of the Government is denied. ☆

D. C. tax institute November 28-30

THE TAX INSTITUTE which has been held for some years at the American University, Washington, D. C., has been reconstituted under the leadership of Hugh C. Bickford, Washington attorney. The Institute will continue to be sponsored, as in the past, by Virginia, D. C., and Maryland CPAs, and the D. C. bar association. This year's meeting will be at the Shoreham Hotel, Washington, November 28, 29 and 30. A workshop technique will be used, based on results from several thousand questionnaires sent to practitioners in the area seeking advice on the questions of greatest interest to them. Eighteen speakers are scheduled. ☆

Rep. Mills to speak at Tax Forum dinner

WILBUR MILLS, chairman of Subcommittee of the Ways & Means Committee on Internal Revenue Revision, will be the speaker at the annual dinner of the Federal Tax Forum of New York on December 6 at the Hotel Biltmore. The hearings conducted by Mr. Mills' committee on revision of our tax system to close loopholes in the present law should then be at their height, and many tax men expect Mr. Mills to make significant comments on his investigation. ☆

AMA releases monograph on management and taxes

WE HAVE just received a copy of the American Management Association's Special Report No. 10, "Management and Taxes", being the proceedings of their meeting in New York in April under the same title. The book contains papers by tax men from many of the country's largest corporations. Excerpts from some of these papers have appeared in THE JOURNAL OF TAXATION in recent months. Copies may be obtained from AMA, 1515 Broadway, New York 36. Price: $3.75 per copy. ☆

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CORPORATE & PERSONAL PROBLEMS IN

Taxation of compensation

EDITED BY JOHN P. ALLISON, LL.B.

Premiums for insured retirement plan are dividends; IRS picks a strong case

THAT 98 PER CENT stockholders and the corporations they control don't deal at arm's-length is a fundamental tax fact. That sometimes 98 per cent stockholders are tempted to try to get a tax deduction through the corporation for a truly personal item is also common knowledge. Many times they take the step with a hope and a prayer, and when the IRS and the courts say no, the resulting case should not frighten closely-held corporations which do try to deal in a normal, businesslike way. It seems to us that the *Casale* case (noted on page 344) is a very strong case for the Commissioner: the retirement plan covered only one employee, the business history of income and salary was short and highly fluctuating, and the annual premium exceeded 15% or 25% of compensation that could be put into a qualified pension or profit-sharing plan. No dividends had ever been paid. The deferred pension and the insurance which funded it were parts of the same package. Because the IRS did pick such a strong case to litigate this point, we would hesitate to conclude that *any* insurance funding would meet the same fate. And because evaluation of the importance of this decision must rest on the facts here, we think study of the facts and opinion necessary.

Following this article is extensive comment and analysis of the implications of this case by Robert J. Lawthers.

The facts of the case

Here are the highlights from the finding of fact in the case.

This proceeding involves a deficiency in income taxes . . . for the year 1950 determined . . . against Oreste Casale.

During the taxable year, petitioner was the president and principal stockholder of O. Casale, Inc., organized October 1, 1946, owning 98 of the 100 shares of its outstanding stock. The other shares were owned by his daughter and by an employee.

As president of the corporation, petitioner was authorized to receive an annual salary of $20,000. In the years 1947 to 1950, he received as salary the following amounts:

1947	$20,000.00
1948	11,833.63
1949	8,043.60
1950	7,454.49

During the taxable year, the corporation was engaged in the manufacture of topcoats, overcoats, and raincoats for various retail organizations. These organizations purchased their own material, had it cut, then the corporation made it into the finished product.

The corporation's fiscal year ended September 30. Its profit-and-loss statements for the fiscal years ended in 1947 to 1950, inclusive, showed net profits as follows:

1947	$28,427.56
1948	19,107.83
1949	1,368.61
1950	(295.32)*

*Indicates a loss.

At no time since its incorporation did it pay any dividends to its stockholders.

On December 7, 1948, a meeting of the corporation's board of directors was held. A resolution was passed authorizing the corporation to enter into a contract with petitioner, whereby it would obligate itself to pay to him, upon certain stated contingencies, a certain monthly income upon his reaching the age of 65 years, or, if he should die prior thereto, a certain sum to his nominees or his estate . . .

On the same date, December 7, 1948, the corporation entered into a deferred compensation agreement with petitioner as authorized. The agreement recited that inasmuch as petitioner had rendered to the corporation services in excess of the compensation paid therefor, and as the corporation was indebted to him for a large measure of its success and desired that he continue in his capacity as its president and treasurer, the parties agreed that additional, but deferred, compensation should take the form of a pension, under which petitioner was to receive a monthly income of $500, commencing on the December 7th nearest the date upon which he attained the age of 65 years, and to continue throughout the remainder of his life. In the event of his death on or after the due date of the first payment, and before the payments had been made throughout ten full years, the corporation agreed to continue the monthly payments to his daughters and his brother, until the expiration of the ten-year certain period. Petitioner had the right during his lifetime to change the designation of beneficiaries under the agreement, and if none survived him, it was agreed that the payments were to be made to his estate. If he should die before the first payment became due, the Corporation agreed to pay to his nominee, or if none, to his estate, the sum of $50,000. Should he voluntarily leave the employ of the Corporation against its wishes, prior to the age of 65 years, or such earlier retirement date as might be agreed upon by the parties, or should he, subsequent to retirement, accept employment from any competitor of the Corporation without the Corporation's consent, then it was provided that petitioner, or his nominees, would forfeit all right to any payments coming due by virtue of the agreement.

On December 7, 1948, the Corporation applied to The Equitable Life Assurance Society (hereinafter referred to as Equitable) for a life insurance policy in the principal sum of $50,000 insuring petitioner's life for the benefit of the Corporation.

The Corporation possessed the right to assign the policy; the right to change its beneficiary; the right to receive dividends as declared by the insurer; and the right to borrow on the policy in an amount not exceeding its loan value.

At the time of the issuance of the policy the petitioner was 52 years old.

The Corporation paid the annual premium of $6,839.50 on said insurance policy for the years 1948, 1949, and 1950.

During 1950, the Corporation kept its books and reported its income on the cash-receipts-and-disbursements basis. In computing its taxable income for such year, it did not claim a deduction for the premium it paid on the insurance contract, but charged it against earned surplus. The policy was always treated as an asset of the Corporation on its books.

The Opinion

Respondent's determination is based on the theory that the majority stockholder of a closely-held corporation receives a distribution equivalent to a taxable dividend when corporate funds, which have been expended for his personal use, bestow upon him an ascertainable economic benefit. He argues that the transaction between petitioner and the corporation, when viewed as a whole, was lacking in bona fides, and, in effect, was no more than a device whereby petitioner purchased a retirement annuity for himself with corporate funds.

The pivotal point for decision in the case before us is whether or not the transaction, whereby the compensation agreement was executed and the insurance contract purchased, was a sham for tax purposes.

Had petitioner taken out the policy, and provided that its benefits were to be paid either to him or his designated beneficiaries, and had the corporation merely paid the annual premiums as they became due, such annual payments would have constituted income to petitioner. Although that is not the factual situation before us, the distinction between that result and the result here is so slight as not to be material. We recognize the policy was taken out upon application of the corporation, and was carried on its books as a corporate asset. We further recognize that all benefits due under the insurance contract were payable directly to the corporation, and that any future payments to be made to petitioner technically would go to him from the corporation and not from the insurer. However, by virtue of the compensation agreement, petitioner was given the right to designate the beneficiaries of either the death benefits or the retirement income payments which might be due him, and was also given the right to change any such designations.

Considering the features of the policy in conjunction with the provisions of the compensation agreement, we must conclude that the corporation was no more than a conduit running from the insurer to petitioner, or his beneficiaries, with respect to any payments which might come due under the insurance contract. Essentially, petitioner stood in the same relationship to the policy as if he had taken it out himself and the corporation had paid the premiums for him. The similarity in terms between the policy and compensation agreement afford recourse to no other conclusion.

The necessity for such a conclusion becomes more apparent when we consider the position petitioner occupied in relation to the corporation. For all practical purposes he was the corporation. He maintained complete dominion and control of its every move; and any future disposition of insurance proceeds would be subject to his assent and approval.

Petitioner contends that had the corporation chosen to fund the agreement by the accumulation of a cash reserve, or by investment of its funds in the purchase of securities, he would not then be deemed to have received a taxable distribution; and he therefore concludes, there being no distinction between that method of funding the agreement and the one herein involved, that the premium payment should not be considered as representing a taxable distribution. Such an argument overlooks the fact that the insurance contract immediately inured to petitioner's benefit, while a cash accumulation or purchased securities would not in the absence of some further act, but would remain a general asset until actual distribution or liquidation. Upon payment of the first premium, petitioner received an immediate economic benefit in the form of a $50,000 life insurance estate, and a retirement annuity contract.

Petitioner further argues that his rights under the compensation agreement were subject to forfeiture in the event he left the employ of the corporation prior to retirement at age 65, or entered into competition with it thereafter. Because of such provisions, he contends that we should consider the benefits provided for by the agreement as conditional until the year of their actual cash receipt, and therefore not taxable in the year in issue.

As a practical matter, petitioner's rights under the compensation agreement were not of a forfeitable nature during the taxable year. This is the only conclusion which can be drawn from those paragraphs of the agreement which set forth the conditions of forfeiture.

To sustain petitioner's argument of forfeitability in the light of the record would be a gross distortion of fact. As he controlled the corporation by virtue of his stock ownership, his assent was the corporation's assent, his wishes the corporation's wishes. He, in fact, did nothing more than agree not to leave the corporation before the age of 65, or enter into competition therewith, unless he should decide to do otherwise. Conditions of such a nature are mere recitations having no substance or meaning.

In short, we conclude that petitioner failed to maintain an arm's-length relationship in dealing with his corporation. As we said in *Wilhelmina Dauth*, (42 B.T.A. 1181, 1189):

"The test to determine whether a transaction is a bona fide transaction is described by the term 'arm's-length,' or, in other words, Was the transaction carried out in the way that the ordinary parties to a business transaction would deal with each other?"

An attempt to fit the transaction before us into such a framework would be extremely difficult, if not impossible. Though the compensation agreement recited that for "many years" petitioner had rendered services to the corporation in excess of the compensation paid therefor, such was not the case. In fact, the corporation had only been in existence for two years at the time the agreement was executed; and, since there is nothing in the record to the contrary, we must presume petitioner's salary to have been adequate in relation to the services rendered therefor. Considering the brief relationship between the parties, the failure of the corporation to declare dividends, and the liberal benefits provided by the agreement, we cannot say that these were "ordinary parties to a business transaction."

Looking beyond the formal recitations of the compensation agreement and the insurance contract to their practical effect, we conclude that the transaction, when viewed in its entirety, lacked bona fides and was merely a device whereby petitioner attempted to avail himself of corporate funds without incurring a tax upon their use. To hold otherwise would require that we ignore the realities of the situation. We, therefore, hold that the sum of $6,839.50 paid by the corporation as the

annual premium upon the insurance contract represented a distribution to him equivalent to a taxable dividend in 1950. ☆

The income and estate tax implications of this decision are potentially serious. Perhaps it will be reversed on appeal. Meanwhile, tax advisors and insurance men should proceed with caution. Certainly it is appropriate to include, where possible, other non-stockholder employees. Moreover, such an obvious tie-in between the plan and the insurance should be avoided.

Weakness in Casale decision: insolvency could destroy benefit to owner-employee

by ROBERT J. LAWTHERS

The Casale decision seems right in all respects but one: what would have happened if the corporate-employer had become insolvent before the insured received any benefits? Evaluation of this point will influence future use of insurance in similar situations.

WHAT DANGERS are there that arrangements may be held to be an income tax sham when they are negotiated by an individual who sits on one side of the table as an employee of a corporation and simultaneously sits on the other side of the table as a stockholder or director of the same corporation?

If, in order to fund some agreement between them, a corporation insures the life of a stockholder and pays the premiums on that insurance, will the insured stockholder suffer unfavorable tax results which might not have arisen had some other investment been made to fund the agreement? Will the insured stockholder encounter unfavorable tax results even though the corporation is the policy's sole beneficiary, payee, and owner—and even though no trust or escrow arrangement is imposed on the policy?

These and related problems arise in connection with the Tax Court's decision in the *Casale* case. This involved a deferred compensation agreement between a stockholding employee and his corporation, in connection with which the corporation had taken out insurance on the life of the stockholding employee. The Court's decision merits the most careful study and thought respecting its possible implications in any situation where life insurance is carried by a corporation on the life of a stockholder.

One weakness in court's conclusion

This case gives an important indication that the courts will cut through transactions between a stockholder and his corporation and, when they are not negotiated at arm's-length, may hold them to be a sham for tax purposes. Considering the circumstances of this case, it is difficult to take exception to what the court says respecting the deferred compensation agreement. One feels the force of the court's rejoinder to every argument made by the taxpayer—except one. On this one point—and the point is critical—it is difficult to follow the reasoning of the court.

The taxpayer had claimed that the transaction was essentially no different than if the corporation had established a reserve in cash or securities. The court tossed this aside on the basis of an immediate benefit provided for the taxpayer by the purchase of the insurance policy.

Even granting its assumption of complete control of the corporation by the insured, the court failed to take account of one possible set of important circumstances which stood between the insured and his certainty of enjoyment of the corporation's premium payment: namely, the possibility of the corporation's becoming insolvent.

A portion of the premium paid by the corporation was used to establish a cash value in the policy. Despite the most complete control by the insured over the corporation, that cash value, until actually used for his benefit, could be reached—even many years hence—to satisfy the demands of any creditors of the corporation.

Furthermore, there was not even immediate certainty of the insured's enjoyment of that part of the premium applied to the cost of insurance protection for the current year. Upon the death of the insured during that year, the entire policy proceeds would be paid to the corporation. Should the corporation be insolvent, payment of those proceeds could not be made to the beneficiaries of the insured, despite the contract between the insured and the corporation. Creditors must come first. And, even assuming the deferred compensation agreement to stand up as having been made in good faith and at arm's-length for purposes of establishing an obligation of the corporation, the insured and his beneficiaries would merely be among the many possible creditors. On the other hand, if, even for purposes other than tax purposes, the deferred compensation agreement had been held to be an agreement to pay dividends, then, in the event of insolvency, the insured and his beneficiaries would have no rights with respect to the policy or its proceeds unless all of the creditors could first be satisfied.

It is unfortunate that counsel for the taxpayer did not make this point definitely and emphatically.

Understanding of insurance needed

Assuming that no trust or escrow arrangement was imposed on the policy, it seems that the court should have given due consideration to the conditional nature of the benefits provided for the stockholder on the basis of the possible use of the policy, its cash value, and proceeds for the benefit of the corporation's creditors. Agreed that there might be situations in which the possibility of insolvency would be so remote that it might be ignored, this will not usually be the situation when a corporation is engaged in business, and it seems very unlikely that it was the situation with respect to O. Casale, Inc.

One does find some tendency for the taxing authorities, and even the courts, to assume that an insured derives benefit merely by reason of the payment of a premium of a policy on his life, irrespective of the ownership of the policy and irrespective of the persons who will benefit from it and the objectives to be served by it. There is no question that an insured can be held to derive a benefit from the payment of a premium on such a policy, even though he has no

incidents of ownership therein. However, when the insured has no such incident, it is necessary that the policy be for the benefit of those he would wish to benefit, or that it serve a personal purpose of his, in order for him to have tax liability on account of premium payments.[1]

Other ways court could have gone

The court did not need to decide the case this way in order to save the Government revenue and to prevent tax avoidance through a sham transaction. It could have[2] treated the payment of premiums exactly as it would, and could, have treated the accumulation of a reserve in either cash or purchased securities. Let us see what could have been done on this basis, conceding the sham nature of the deferred compensation agreement.

Any payments made by the corporation to the stockholder, following his retirement, could have been taxable to him as dividends and not deductible by the corporation. The corporation would thus lose the deductions to which it might be entitled in the case of a bona fide agreement with payments made as compensation for services.

At the death of the insured, the payments to the widow, or other nominee of the insured, would not be compensatory and thus would not get the advantage of the employee $5,000 death benefit.[3] A court could properly hold them to be dividends and thus taxable to the recipient but not deductible by the corporation.

The proceeds of the insurance received by the corporation would increase the value of the corporation. The payments to the widow or other nominee of the decedent could be held to constitute an agreement to pay dividends, and not an ordinary obligation of the corporation. Thus, in valuing the corporation, no offset would be allowed on account of its liability to make the payments. The insurance proceeds would increase the value of the stock of the decedent for estate tax purposes, and the effect would be as though the proceeds had been included in his gross estate.

It may be claimed that this would still permit the stockholder to get an advantage through the deferring of the time when income would be taxed, as compared with his currently being taxed were a distribution made to him and had he paid premiums on a personal policy. However, to the extent that this can be done, it is possible by merely accumulating profits for later distribution. One does not need a deferred compensation agreement or life insurance on a stockholder's life to do this sort of thing.

However, the Commissioner has a remedy which is just as available when there is a deferred compensation agreement and when there is life insurance as when there is not: namely, the penalty tax of Section 531 of the 1954 Code.[4] This remedy would have been available in the *Casale* case. If the deferred compensation agreement was a sham and was an agreement to pay dividends rather than compensation, then a reserve established against such obligation would not be a reserve accumulated for a business purpose, and earnings added to such reserve could be subject to the penalty tax of Section 531. The fact that the reserve might be so established through the medium of a life insurance policy would make no difference.[5]

The importance of this case

Although I believe the decision to be illogical and unsound insofar as it relates to the effects of a corporation's acquiring a life insurance policy, nevertheless the decision cannot be ignored. Unless the decision is appealed and the Tax Court is overruled, we will have a distressing situation to confront us, probably for some time to come.

Despite my opinions respecting this decision, I would not suggest recommending that a client in a position similar to that of Mr. Casale enter into a similar agreement and similarly arrange for the purchase of a policy on his life. This decision gives an indication of the position the Commissioner may be expected to take and of the probable position of the Tax Court. Few clients wish to buy more than an even chance of litigation in order to avoid undesirable tax consequences of their acts.

Beyond this, however, some will see all sorts of peripheral applications of this decision. One could not argue very strongly against the tax practitioner who might fear similar results when several employed stockholders, who together own most of the stock of a corporation, act like Mr. Casale. There may also be reason to fear similar action for an employed stockholder when the remaining stock is owned by close relatives. On the other hand, it may be argued that one would be getting overpanicky if one saw the spectre of income tax liability to the insured in every case of a deferred compensation agreement for an employed stockholder with insurance taken out for his benefit. It is difficult to see how the reasoning of the court in the *Casale* case could be extended to an arrangement made for one minor stockholder, or for a group of stockholders who together own only a minority of voting control, provided, in either event, remaining stock is not owned by relatives.

Possible broad application

Some may fear an even broader application of the basic philosophy of this decision. Although it deals with an employment contract, and although it deals with life insurance taken out in connection with an employment contract, the philosophy appears to have at least some applicability to any situation in which controlling stockholders take advantage of their corporation to have it pay premiums on insurance which is taken out primarily for personal objectives rather than for corporation objectives, even though this might appear as key-man insurance or insurance for stock redemption purposes.

It is difficult to isolate the fulfilling of personal needs of a stockholder from the fulfilling of needs of that separate

[*Mr. Lawthers is Director of Benefits and Pension Business of the New England Mutual Life Insurance Company. He is a frequent speaker at tax institutes and insurance conferences, and writes often for tax publications.*]

[1] I believe it can properly be maintained that there cannot be held to be a distribution to the insured sufficient to warrant imposing an income tax liability on him, so long as there is uncertainty that a policy and its proceeds will inure to the benefit of the insured, or those he would wish to benefit, on account of there being a colorable chance that they may inure to the benefit of the creditors of the corporation which is paying the premium.

[2] In my opinion it should have.

[3] IRC Section 101(b).

[4] Section 102 of the 1939 Code.

[5] It is true that for the year 1950 this remedy would not have been available, since there were no profits in that year.

[6] The attitude of the life insurance agent can be of great importance. If he tries to sell corporate insurance primarily to fulfill individual objectives of an insured stockholder, the insurance is likely to be purchased, if at all, for such purposes. On the other hand, if the agent concentrates on business purposes of the corporation in soliciting of the insurance, it is likely that if it is purchased it will have been acquired primarily for corporate purposes.

While the agent will, almost of necessity, informally discuss various ways that the policy may be used by the corporation to fulfill various possible future needs of the corporation in relation to the employed stockholder or his relatives or dependents, this is vastly different from a presentation that would show a basic purpose of a stockholder to feather his own nest in arranging for his corporation to take out insurance.

person, the corporation. Of necessity, what benefits the corporation will probably benefit its stockholders. Beyond this, even when the primary purpose of insurance is clearly to fulfill a corporate purpose, it will be difficult to escape the possibility of secondary purposes the insurance may serve that will be of benefit to the stockholders. Considerable care should be taken that any pertinent corporate resolutions, agreements, or other facts that could be introduced in evidence, all point in the direction of the primary corporate purpose.[6]

Conclusion

I believe the *Casale* decision to be correct insofar as it holds the deferred compensation agreement to be a sham, but not correct insofar as it holds premiums paid by the corporation to be currently taxable income to the insured. I believe that this decision would have been correct if any trust or escrow arrangement had been imposed upon the policy to preferentially devote it to the fulfillment of the deferred compensation agreement. In the absence of this, however, I believe that the situation should have been held to be no different than if cash had been put into a reserve or had securities been purchased to fund the agreement. In this connection, I agree that there might be a necessary weighing of the likelihood of the corporation's becoming insolvent during a period within which the insured stockholder might lose the possibility of being benefited. Occasionally, a situation might be found where the possibility of such insolvency would be so remote as to be properly ignored, but this would in all probability not be true with most businesses.

New compensation decisions this month

Premium paid to fund controlling stockholder's retirement agreement a dividend to him. In order to fund a retirement pension agreement with its president and principal stockholder, a corporation took out a combined life-annuity contract to mature at age 65. The corporation was declared to be the owner of the policy, but the officer, by agreement with the corporation, was given the right to designate the beneficiaries in the event of his death. The court holds the officer's rights under the retirement agreement nonforfeitable; the annual premium of $6,000 paid by the corporation represented a distribution equivalent to a taxable dividend [See comment and discussion, pages 340-344. *Ed.*] *Casale,* 26 TC No. 131.

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Pension plan not defective because employer is preferred creditor. An employee's pension, profit-sharing, or stock bonus plan will not fail to qualify under Section 401(a) of the 1954 Code merely because it contains a provision exempting the employer, if it is a creditor, from the general provision that the rights of the employee under the plan are not subject to the claims of creditors. *Rev. Rul.* 56-432.

Profit-sharing plan may pay cash currently to some and defer benefits for others. An employee's profit-sharing arrangement which provides for cash payments to some participants and deferment by funding through a trust of contributions on behalf of others may qualify for exemption if, with reference to the deferred contributions, it meets the coverage requirement and is nondiscriminatory in contributions or benefits. *Rev. Rul.* 56-497.

Lump-sum pension distributions exempt under Canadian treaty. When a nonresident alien residing in Canada was separated from his employment, he received a lump-sum distribution from an employees' trust which was qualified under U. S. law on account of services performed outside the U. S. The distribution is exempt from tax under the Canadian tax convention. *Rev. Rul.* 56-446.

Worked at home; pay isn't sick pay. Taxpayer, though ill, carried on his duties to a large extent from his home. Because he was chairman of the board and chief executive officer, the usual administrative procedure (investigation, personnel department reports, etc.), were not followed in his case. The court concludes his salary was not considered sick pay by the company. It treats him as having earned the salary. *Hall,* DC Ind., 8/2/56.

Can't separate legal fees for service to incompetent; 80% test not met, no spreading. An attorney received $16,400 in legal fees for services in prosecuting claims in behalf of an incompetent from 1944 through April 1946. Later, in 1950, he was awarded by court order additional fees of $10,300 for the services in the same litigation during the period April 1946 to October 1947. The court holds the services were continuous. Since the amount received in 1950 was less than 80% of his total compensation, the income-spreading benefits of Section 107(a) are not available. *Howard,* TCM 1956-219.

Salesman cannot isolate particular sales for income-spreading benefits. Taxpayer was employed as Washington sales representative for a manufacturer of automotive equipment. Services which he rendered over 37 months in the sale of 240 tanks to the Chinese government are held to be part of his general duties. It could not be isolated as a separate employment for purposes of qualifying the compensation under Section 107(a). *Reynolds,* 26 TC No. 155.

Spouses can split and carry back long-term fee despite joint returns in prior years (old law). In 1948, husband received a fee for legal services rendered from 1936 to 1945. He and his wife filed joint returns for 1948 as they had done in some of the prior years. They computed the 1948 tax by dividing the fee into two equal parts and allocating each half to the years during which the services were performed, as though separate returns had been filed. The Third Circuit affirmed the Tax Court. [Under the 1954 Code, long-term compensation cannot be split when carried to years prior to 1942. *Ed.*] *Stockly,* 22 TC 28, *acq.* 1956-37. Acquiescences are published for similar cases: *Mahler,* 22 TC 1180, *acq.* IRB 1956-37; *Jolson,* 22 TC 1101, *acq.* IRB 1956-37.

TAX STRATEGY NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B. CPA

Commissioner Harrington explains new informal conference procedure details

"WE STRONGLY BELIEVE that the new informal conference procedure we have recently announced will attain general approval in most quarters," says Commissioner of Internal Revenue Harrington. "Obviously, it is impossible to come up with an answer that is entirely satisfactory to everyone, but we have set out to change the existing procedure to keep as much of the informal, low-cost aspects as possible."

Departure from present system

"Our presen: informal conference procedure was established under the Reorganization Plan of 1952," he said. "This is the machinery set up at the district Audit Division level to resolve, as early and as informally as possible, the disputes between the taxpayer and the Revenue Service." Mr. Harrington continued:

A major objective of the revision was to bring the disposition of disputed cases closer to the taxpayer, to give him an opportunity to present his case at the least cost, and with a minimum of fuss and bother. We thought thus to increase the opportunity for early taxpayer protests, for agreements before the preparation of the revenue agent's formal report, and to reduce the need for the more-costly formal protests at the Appellate Division level.

Key man in this system has been the supervisor of each group of revenue agents. Besides supervising the work of his "team" of agents, he usually also serves as the conferee in attempting to resolve the differences which arise between the agents and the taxpayers.

Some no doubt remember that, prior to reorganization, a specialized group of conferees, functioning more or less independently of the revenue agents and their supervisors, carried out the conference activity at the Audit Division level of the Service's organization.

This more-formal system was also more costly, and many of the relatively-small cases that are protested today were formerly agreed to by taxpayers because of the relatively-high cost of the conference procedure.

Since there was also an Appellate Division function prior to reorganization, as there is now, the prior administrative appeals procedure in effect had two formal conference systems. In other words, the present informal conference procedure is a substitute for the prior more-formal conference procedure at the district Audit Division level. The Appellate Division procedure is about the same now as it was prior to the reorganization of the Service.

This objective of making the informal conference less formal and less costly to taxpayers is a desirable objective which the Service will continue to strive to attain. In practice, however, imperfections developed, along with a great deal of conflicting opinion as to its desirability.

Investigation of dissatisfaction

When we were convinced that a real problem existed in this area, we took a first step toward its solution early this year by undertaking a rather thorough survey of opinion on the matter, consulting representative taxpayers, tax practitioners, both lawyers and accountants, and our own field officials and technicians.

The results of this survey were somewhat surprising. There was an almost equal division of the respondents among three groups: those endorsing the present informal conference procedure wholeheartedly, or with only minor modifications; those liking the basic aspects of the present informal conference procedure, but proposing major modifications; and, those opposing the informal conference procedure entirely, or with such drastic modifications as would, in effect, virtually eliminate its informal aspects.

Informal qualities preserved

We interpreted the results of our entire survey to mean that the desire to keep the present informal conference unchanged is clearly a minority attitude. Similarly, the desire to eliminate the present informal conference is also a minority attitude.

We therefore set about to change the existing procedure to keep as much of the informal, low-cost aspects as possible; but to provide the flexibility our operating experience indicates that we need and to allow for some of the recommendations received.

Audit Chief now responsible

Our first major change is based on the premise that many of the currently defective aspects of the informal conference stem from the fact that there has not been completely effective direction or control of the informal conference function. We are therefore assigning specific responsibility for the direction and execution of this function in each District Office to the Chief of the Audit Division. Where the Chief is personally unable to discharge these responsibilities, he may delegate them to a conference coordinator under his immediate direction.

Most of the larger offices will have a full-time conference coordinator. Some of the largest districts will also assign one or more conferees to assist the coordinator.

In many of the smaller districts, the duties of the conference coordinator will be assigned to a competent Audit Division official as an adjunct to his regular duties.

In all districts, the conference coordinator, whether full-time or part-time, will be a highly capable technical employee who has demonstrated his ability to deal effectively with taxpayers and their representatives. He will also have the qualifications necessary to provide leadership and competent guidance to the Service's group supervisors and other personnel on the informal conference function.

Obviously, great responsibilities rest upon the conference coordinator in making the revised informal system work well. I should like to mention some of

these responsibilities, as they are outlined in our instructions to our field personnel, in addition to the basic responsibilities for direction and execution of the entire informal conference function.

The coordinator will review informal conference notification letters in those cases in which the taxpayer has requested an informal conference, and he will assign these conferences to appropriate Audit Division personnel.

We expect that requests for informal conferences on run-of-the-mill cases will continue to be assigned to the examining officer's group supervisor as under the present procedure. However, the coordinator will make other arrangements, where necessary, to achieve an informal conference to the best interests of both the taxpayer and the Service.

The examining officer's group supervisor is not likely to be the conferee in large, time-consuming cases characterized by a multiplicity of difficult issues. The coordinator will also consider other factors in deciding the appropriate conferee to assign to each case, such as representations made by the taxpayer and his representatives, the group supervisor's recommendation, and other related information.

In this way we intend, insofar as practicable, to provide every taxpayer with the type of conference best suited to the circumstances in his specific case.

Flexibility will be retained

We recognize that it is impractical to expect a rigid system or procedure to fit the extremes of the range of cases for which taxpayers request informal conferences.

We are therefore attempting to introduce sufficient flexibility into the informal conference procedure to answer the different needs, for example, of both the large-corporation case with many complicated issues and the relatively-simple case of a nonbusiness deduction question with equal satisfaction to the two types of taxpayers and the Service.

The conference coordinator will have a number of other duties, including the furnishing of technical advice to conferees; the conducting of conferences in the more difficult cases or in cases involving issues in which he is particularly qualified; the achieving of technical uniformity in informal conference cases involving the same or similar issues; and the screening of all formal protests filed by taxpayers for the purpose of deciding whether further action is required by the Audit Division prior to referral of the case to the Appellate Division.

I believe these aspects of the new informal conference framework are those which are most important to practitioners in their future dealings with the Service. The rest of the details will soon become obvious in their actual tax practice.

I consider the revision of the informal conference machinery one of the most important procedural developments of the year. We sincerely hope and expect that the new system will enable us to render better service to tax practitioners, and to their clients and ours, the taxpayers. ☆

RE-ENROLLMENT FOR TREASURY PRACTICE REQUIRED

WHEN THE SECRETARY OF THE TREASURY terminated enrollments to practice before the Department in 1952, he provided for renewals for five years only. This five years expires next year, making renewal necessary.

"It was estimated that about 55,000 renewal cards were issued between January 1 and June 30, 1952", says George C. Lea, Director of Practice of the Department. It was also estimated that some 6,000 enrollment cards were issued as a result of original applications filed in 1952. After the termination by the Secretary of all enrollments, a period of five years from the issuance of the card having been prescribed, it is estimated that about 62,000 cards will expire in 1957. Upon expiration they will be null and void and of no effect whatsoever.

"It is anticipated that there will soon be published in the Federal Register notice of an amendment of the regulations covering renewal procedure and thereafter instructions will be publicized as to the details of carrying out such procedure.

"It is believed that such procedure to be announced will not vary materially from that followed in 1952; that it will provide for renewal by filing a short form application designated Form 23-A; that such form may be obtained and filed in the Internal Revenue Region in which the applicant resides; that it will be processed there unless there is reason to believe the answers given by the applicant to the questions thereon are not favorable or not truthful; that in such event they will be processed in the office of the Director of Practice after investigation and pursuant to a procedure that will satisfy the requirements of due process of law; that a reasonable time will be specified for the submission of such renewal applications; that the submission of a renewal application within the specified time will give the applicant the advantage of such summary procedure; that working space will be provided for the processing of renewal applications in said estimated volume by the Department but with provision for temporary recognition while awaiting the taking of final action."

IRS School program revised, expanded

A NEW EDITION of the Internal Revenue Service's "Federal Income Tax Course," for use in teaching students of high schools and secondary schools basic income tax facts and how income tax returns should be prepared, is being readied for free distribution this fall.

Forms for use in ordering copies of the new course have been mailed to more than 30,000 public, parochial and private secondary schools of the nation.

Included are instructional materials for the so-called "General Course," which is directed to students in our city and urban areas, and the "Farm Course" which is for use in the more than 10,000 high schools and secondary schools in the rural and farm areas of the country. Instruction manuals are provided for the teachers, and each student is furnished a handbook to be used in following at their desk the instructions given by the teacher. The students' handbooks contain illustrations of filled-in return forms and also sample problems and blank forms for completion to provide for practice in filling in returns. The Farm Course includes a section on record keeping of farm income and expenses on both the "cash" and "accrual" methods of accounting. ☆

New procedural decisions this month

General order to third party to produce all records is illegal search and seizure. Defendant is the surviving spouse of one who appears to have been the moving factor behind a building company, whose books and records were subpoenaed by the Special Agent investigating the tax liability of two individuals who transacted business with the building company. She refused to produce any of the subpoenaed books and records on the ground that the government might make a tax claim arising either out of the affairs of the building company or her deceased husband and attempt to pursue certain property which had been transferred to her by her deceased husband. The district court held however that since such possible tax claim would be a civil proceeding, the Fifth Amendment would not excuse production of the books and records on that ground. It further held that the examination was necessary to accomplish its purpose and that the subpoena did not constitute an unreasonable search and seizure. Moreover, the materiality of the books and records to the investigation of another's tax liability could be raised, if at all, only by the one who is being investigated. This circuit court reverses and refuses to enforce the subpoena. The proper procedure, it says, would have been to examine her as to the records she had and if they bore on the affairs of the taxpayer being investigated to subpoena them specifically. A general subpoena is an unreasonable search and seizure. *Hubner,* CA-9, 9/21/56.

Late claim no good though Commissioner studied it. Taxpayer, the opera singer, Lauritz Melchior, claimed a refund of some $80,000 because of loss of property in East Germany. The claim is barred by the ordinary statute of limitations. This is so even though the Commissioner did consider the claim on its merits. The statutory requirements of a timely claim cannot be waived. If taxpayer asks for a "war loss" it must be denied because such losses are deemed to occur in 1941. *Melchior,* Ct. Cls., 10/2/56.

Can't enjoin collection of assessment; administrative remedies still untried. Taxpayer sought to enjoin the collection of an assessment which, he claimed, was made too late. The court denies the injunction. The assessment was for alleged fraud which, if proved, would lift the bar of the statute of limitations. Moreover, taxpayer had not exhausted his administrative remedies: he had not petitioned the Tax Court. Although the period in which he could file that petition had expired, he can still pay the assessment and sue for refund. *Boren,* DC Calif., 5/3/56.

Tax Court petition setting forth a claim for refund was adequate notice to the Commissioner. Taxpayer was sent a notice showing an income tax deficiency and an excess profits tax overassessment. He did not file a claim for refund on Form 843 but filed a petition setting forth his claim with the Tax Court. The Tax Court forwarded two copies of the petition to the Commissioner, and it was processed as a claim for refund. An amended claim filed on Form 843 after the statute of limitations had run is a valid amendment of a timely-filed claim. *Rushlight & Co.,* DC Oreg., 8/31/56.

Inactive corporation retaining some assets must file 1120. If a corporation has ceased all business operations but has retained a small sum of cash to pay corporate state taxes to preserve its charter, it must file a Federal income tax return. [The Regulations require that all corporations file returns; however, if a corporation is still alive under state law but does no business and retains no assets, the Regulations classify that corporation as ceasing to exist. *Ed.*] *Rev. Rul.* 56-483.

IRS can't back out of stipulation. [*Non-acquiescence*] The court refused to grant the Commissioner's motion to withdraw a stipulation of settlement. He failed to show that his representatives made a mistake in filing the stipulation or were unaware of the points which he now wished to press. The Commissioner had argued that statements in an affidavit filed by taxpayer falsely represented that taxpayer was not a "primary obligor" of a certain corporate note. The court, however, held that the affidavit did properly refer to taxpayer as an accommodation-maker and as such did not mislead the IRS. *Saigh, Jr.,* 26 TC No. 18, *non-acq.,* IRB 1956-39.

Transferee assessment not valid; she wasn't transferee. Asserting transferee liability against taxpayer for her brother's taxes, the Commissioner collected the rent of certain property recorded in her name. The court holds (1) she was not her brother's transferee because she immediately endorsed and returned to her brother the capital stock which was allegedly transferred and (2) she was a mere holder of record title for the real property which belonged to her father. *Potnick,* DC Pa., 8/17/56.

Trustee liable as transferee for tax debt of insolvent grantor. Taxpayer's husband, who owed Federal income taxes plus penalties and interest in excess of $63,000, gratuitously transferred property to his wife in trust for the benefit of his grandchildren. In a prior proceeding the court held the transferor was insolvent at the time of the transfer. Upon rehearing, the court affirms its prior finding of insolvency and holds the wife as trustee-transferee liable for the debtor's taxes. *Smith,* TCM 1956-213.

Notice of mathematical error not a "deficiency notice." The Commissioner notified the taxpayer that he was not entitled to claim a credit on his return for an estimated tax payment because the period of limitations with respect to the credit had expired. Notification was not made by regular deficiency notice but by a notice of mathematical error. As the Commissioner's claim was not based on an error in arithmetic, his notice was held insufficient as a deficiency notice. *Repetti,* CA-9, 9/7/56.

tax problems?

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TAX ASPECTS OF ESTATE PLANNING

Estate & gift taxation

OF INTEREST TO TAX PRACTIONERS

Tax considerations in gifts to minors made under new state custodian laws

by DANIEL G. TENNEY, Jr.

Action by the IRS has been eagerly awaited on income-tax treatment of gifts to minors using the new statutory custodian. Now, in a new ruling, the IRS confirms widespread belief that income from such gifts will be taxed to the person having the obligation of support. But many tax men doubt the validity of this position, saying that the Treasury may be exceeding its statutory authority. The following analysis of income-, estate-, and gift-tax consequences relates the new ruling to other considerations, and provides a simple, but thorough, picture of the points to watch in using the statutory custodian

THIRTEEN STATES and the District of Columbia now have in effect substantially identical statutes providing a simple method for making gifts of securities to children. The Commissioners on Uniform State Laws have adopted a version which follows the same pattern and which will be subject, in all probability, to exactly the same tax considerations as the existing legislation.

The concept of the statutes[1] is a very simple one. By following the simple procedure outlined in them, the donor effectively makes a gift of the securities in question to the child and appoints either himself, or a member of the child's family, to be "custodian" of the property in question during the child's minority. This amounts to the appointment of a guardian of the specific property, limited in its scope and effect to the particular subject matter. The "custodian" is given the power to sell the securities and to reinvest the proceeds, income and other cash receipts, but the property in the custodian's hands is and remains the property of the child in every respect.

Not all the tax consequences to the donor, the custodian and the child are as yet fully established.

Revenue rulings

1. *Revenue Ruling 56-86* recognizes that such gifts come within the purview of Section 2503(c) of the Internal Revenue Code of 1954 and, consequently, qualify for the annual gift tax exclusion. So far as the donor is concerned, therefore, it is clear that he does not need to pay any gift tax in the year of gift if not more than $3,000 (or $6,000, if joint with spouse) is given to any one child in that year. The possibility of subsequent gift tax consequences to the donor or custodian is discussed later in this article.

2. *Revenue Ruling 56-484* [see summary at page 351, this issue. *Ed.*] charges the infant with income not used to discharge another's obligation to support the infant, and charges the person having the obligation of support with income actually used for that purpose. This ruling conforms with the proposed Treasury regulations relating to the income from trusts. See Federal Register, May 2, 1956 (especially proposed regulations under Sections 678 and 662).

Income tax questions

The income tax implications of such gifts are pretty well set forth by the Revenue Ruling just mentioned (i.e. Revenue Ruling 56-484). Some of the difficulties which taxpayers and the Government may have in applying this ruling are suggested in a recent article in THE JOURNAL OF TAXATION, September 1956 issue, at pp. 163-164. There is considerable opinion to the effect that the proposed trust regulations (and thus also this ruling) exceed the statutory authority. For the moment, however, until the validity of the Treasury's position and the limitations upon the application of its rulings and regulations are determined, income from a gift of securities under the statutes ought not to be used to defray obligations of support and maintenance, as this may have adverse consequences to the person having such duty of support.

In so far as income tax consequences are concerned, there would appear to be no disadvantage to using the statutory method as compared with making outright gifts (which would be subject to legal guardianship) or gifts in trust, assuming that the donor wishes to avail himself of the annual gift tax exclusion and therefore keeps the trust provisions within the limits prescribed by Section 2503. On the contrary, income from a statutory gift which is not used to discharge the obligation of support is taxable to the infant (Rev. Ruls. 56-484, *supra*, and 55-469: Widmark, "Security Gifts to Minors," 95 *Trusts and Estates* 698 (1956) who will accordingly be allowed an exemption of $600 plus the standard deduction. It would also appear, from informal inquiries at the Treasury Department, that if a custodian permits an infant's income to accumulate over a period of years and then spends more in a subsequent year than the income earned on the fund in that year, the person having the obligation for support will not be taxed on more than the income actually earned on the fund in that year. In other words, a custodian might accumulate income during a child's early years, the income being taxed as the child's, and utilize that income during a later year of minority without subjecting the child's parents to income tax on a sum greater than was earned on the child's property in that later year.

Estate and gift tax questions

Certain questions have been raised regarding estate and gift tax consequences from gifts under these statutes. To the family of moderate means, the specific gift and estate tax exemptions and the annual gift tax exclusion make such questions largely academic. They do deserve some discussion, however.

Before going into them in detail, it seems desirable to analyze the relationships involved and equate them with other recognized and familiar relationships. First, it should be recognized that a gift under the statute does not create a trust for the child, strictly speaking, because title to the securities in question belongs to the child. The gift is to the child and it is his property. Were a gift of securities made to the child without the use of these statutes, the child could not legally sell the securities, cash dividend checks and collect interest. A guardian would have to be appointed to deal with the securities and income for the child. What the donor does in using one of these statutes is to give to the selected custodian powers of administration similar to those of a guardian for the child appointed by court, except that the custodian's powers are broader and are confined to the property given by the donor.

The relationship among donor, child and custodian is closely analogous to three well-known relationships affecting children's property: (i) It is analogous, as indicated, to legal guardianship, in which the guardian's powers are conferred by statute and court appointment. (ii) It is even more closely analogous to testamentary guardianship and other forms of testamentary powers in trust. It is common practice for testators to provide legacies or other benefits under their wills for children and to appoint guardians of the property, setting out in the will the extent and nature of those guardians' powers. Alternatively, testators may provide that if a legatee or beneficiary is a minor, the executor or some other person designated in the will shall have the power to administer the property during the child's minority. Such testators frequently specify the powers and duties that such fiduciaries are to have. There is no difference whatsoever, in theory, between such testamentary grants of administrative powers to persons other than legal guardians and the grant effected *inter vivos* by utilization of the statute. (iii) Lastly, such gifts are no different from trusts that meet the requirements of Section 2503(c), except that title in the one case is vested in the trustee. The powers that may be given to the trustee may be even wider or narrower than those expressed in the statute, or may be the same, depending on the wish of the donor. Under the statutory form the donor accepts the powers that the particular legislature has offered as a standard.

To sum up, the relationships under the statutes are such that the estate and gift tax consequences should certainly be made to be identical with those of gifts in trust that qualify for the annual exclusion and gifts outright to a child subject to the control of the general guardian, assuming that the same person is custodian, trustee or legal guardian in each case. In other words, the tax consequences should be the same irrespective of which of the three methods the donor selects. His choice of guardian, trustee, or custodian, however, may make a substantial difference to himself or to the custodian or trustee, if large gifts are made or if large funds are accumulated by regular giving. However, to the average donor and custodian the questions are of little practical significance.

Gift tax results

The donor. As already pointed out, gifts under the statutes qualify for the annual gift tax exclusion (Revenue Ruling 56-86) and it is assumed that donors will only use the statute in order to take advantage of the exclusion.[2] It has been suggested, however, that if the donor is also the custodian, and furthermore owes the duty of support to the child, he has reserved to himself, in effect, a power of appointment over principal and income alike and may be subject to further gift tax when that power is either surrendered or expires by reason of the child's reaching 21 years of age or dying. *Note:* "Recent Legislation to Facilitate Gifts of Securities to Minors," 69 *Harv. L. Rev.* 1476, 1482-4 (1956). This would seem to be in conflict with Revenue Ruling 56-86, which concerned a gift by a father to his daughter, naming himself as custodian. The Treasury held that this was a gift of a present and not a future interest. The danger, if any, would lie in the fact that a succession of gifts may have built up the aggregate property given by the donor, over a period of years, to a fund well in excess of the $3,000 or $6,000 limitation which presumably prompted each individual gift. Were a donor-custodian actually to use income or principal, or both, to satisfy his legal obligations, the relinquishment or expiration of such power, after a history of actual use, might lead the Treasury to take the position that the donor-custodian had, in effect, reserved a power to appoint the property to himself. Should none of the principal or income have been used, however, prior to the date when the power expired or was relinquished, it would seem difficult for the Treasury to argue that the donor had actually reserved to himself a power to use the property in discharge of his own legal obligations, *particularly* since the Treasury has recognized the gift as complete on the date of the original transfer. To those donors who might have misgivings about the *future* gift tax implications of such a transfer, however, two possible courses are suggested. First, the donor should appoint someone other than himself as custodian. If it is impossible or impracticable to appoint another as custodian, he might, within the same calendar year as that in which he has made the gift — or before the fund has grown to exceed $3,000 or $6,000, as the case may be — relinquish the power insofar as it may enable him to discharge his own legal obligation to support the child. Such a renunciation should place him in the same category as a legal guardian who is also a donor. (*Cf.* Rev. Rul. 56-484, *supra,* and cases cited therein.) Donors who are concerned about this situation might further protect themselves by filing returns each year in which a gift is made, irrespective of the fact that they might not be obliged to do so because of the size of the gift, revealing the relationship between donor-custodian and child.

A donor need have no fear of future gift tax liability if he does not himself owe a duty of support of the child.

The custodian. The donor may not be the only one, however, who runs the risk of future gift tax liability. 69 *Harv. L. Rev., supra,* at pp. 1484-5. If the custodian owes the duty of support of the child, the unrestricted power—conferred by gifts under the statutes—to utilize the income and principal to discharge the duty of support might be held to give

[*Daniel G. Tenney, Jr. is a member of the New York Bar, and a member of the New York law firm of Milbank, Tweed, Hope & Hadley.*]

[1] The form and content of all the existing statutes and the Uniform Act are so alike that they, collectively, will be referred to in this article as the "statutes" unless occasion arises for more specific reference. The existing statutes, all of which are based on a single model prepared for and sponsored by The New York Stock Exchange Firms, may occasionally be referred to, collectively, as the "Model Bill" and the version adopted by the Commissioners on Uniform State Laws may occasionally be referred to as the "Uniform Act."

[2] If larger gifts are to be made, the flexibility of "custom-tailored" trusts suggests the use of them in preference to the statutory gift.

the custodian a power to appoint to himself, and the relinquishment or expiration of this power might amount to a gift by the custodian to the child. Renunciation by the custodian of the power to employ principal or income in discharge of the custodian's own legal obligation would appear to bring him into the same category as a legal guardian, who is presumed *not* to have the power to utilize the child's income to discharge his own legal obligation. *Cf.* Rev. Rul. 56-484, *supra*. Parents may wish to find another member of the family or other eligible custodian to serve, if this gift tax liability is a serious consideration to them. It would seem remote to the author, unless the power is actually exercised by the custodian to discharge his own legal obligation, and it is questionable whether a custodian would have a legal right to do so unless his own funds were inadequate for the purpose.

Estate tax results

The same theories that inspire the fear of adverse gift tax consequences to donor and custodian alike, subsequent to the date of the gift, have suggested estate tax consequences that should certainly be considered and, to the greatest extent possible, minimized.

The infant donee. If the infant donee dies before reaching the age of twenty-one, the subject matter of every gift made to him under any one of these statutes will naturally be included in his gross estate for tax purposes. This is no different than (a) property owned by the infant subject to the control of a legal guardian, (b) property owned by him and subject to testamentary guardianship, and (c) property held in a qualifying trust under Section 2503.

The donor. If the donor dies within three years of making a gift under one of these statutes, the subject matter of the gift can be included in his estate for tax purposes as having been made in contemplation of death.

If the donor is not also custodian, the possibility that the power might be exercised to the donor's advantage would not seem sufficient to characterize him as having reserved any rights in the property. See Widmark, *supra,* 95 *Trusts and Estates* 698, 700, and cases there cited. See also MacNeill, "Stock Gifts to Minors Act—Ten Months Later," 36 *Trust Bull.* 10, 12 (1956).

The donor who is also custodian, however, may run an estate tax risk even if he owes no duty of support, assuming that he dies before the child becomes twenty-one. In such a case the donor may be held to have retained the right to designate the person or persons who should enjoy the property or had the right to terminate the "trust" aspects of the gift. If the donor-custodian also has a legal obligation to support the child, an estate tax liability might be imposed on the theory that the donor retained possession or enjoyment of the property so given. In each case it would appear advisable for the donor-custodian to relinquish the right to exercise his powers for his own benefit, thus equating himself with a parent guardian.

If custodian dies

The custodian. A custodian who is not the donor will incur no estate tax consequences unless he owes an obligation of support to the infant. If the custodian does owe an obligation of support to the infant and dies either before the infant or within three years after the infant dies or comes of age, estate tax liability might be imposed upon him. The likelihood is slight, however, if the custodian is not also the donor. Widmark, *supra,* 95 *Trusts and Estates* 698, 700. MacNeill, *supra,* 36 *Trust Bull.* 10, 12. Here again, the custodian may well have an effective remedy in the form of renunciation of any power to discharge his own obligations out of the infant's funds.

To sum up, it seems clear that the Treasury will take the position that income from one of these gifts will be taxed to the infant as his own personal income except to the extent that the income is used to discharge another's obligation of support of that infant. Income so used will be treated and taxed as the income of the person having the duty that has thus been discharged, irrespective of whether that person is the donor or custodian or a person entirely unrelated to either.

The breadth of power given to custodians to utilize the infant's property may possibly make such gifts more vulnerable to future gift and estate tax consequences than gifts outright, which are subject to the control of a legal guardian. Gifts in trust would seem to have the same vulnerability as gifts under one of the statutes.

The suggested gift and estate tax consequences seem far-fetched but if they can be avoided or minimized, steps should be taken accordingly and possible steps have been suggested in this article. Such problems as there may be must be faced in any form of gift to an infant and certainly do not impair the usefulness of the new statutory device for giving securities to children. ☆

Estate and gift tax burdens still vary; marital-deduction formula a failure

WHEN THE enormous complexity of the marital deduction was added to the estate tax law, it was justified on the ground that it would bring to common-law states the tax advantages which only residents of community property states previously enjoyed. Was equality ever achieved? The answer is no. One keen student of the subject has worked out the tax costs where spouses own an equal amount of property held either in community, divided in varying proportions between them, or in separate ownership. Additional computations show what happens when the wife predeceases the husband. This study, by Paul E. Anderson, San Francisco attorney who is former Special Assistant of the Chief Counsel, Bureau of Internal Revenue, can be found in the 1956 *Michigan Law Review* at page 1087. Mr. Anderson's conclusions are:

The marital deduction has fallen short of its goal of equalization. On the quantitative side, the major disparity grows out of the fact that the marital deduction is a function of only one spouse's estate, [i.e., is a factor in the computation of tax of only the first spouse who dies] not of the total estate of both spouses (as in the case of community-property splitting). And from the qualitative viewpoint, we find that even more discrepancies exist, brought about in part by the ingenuity of estate planners. A technical rule of disqualification, such as the terminable-interest rule, is an open invitation for the design of plans that fall just outside the proscribed limits but within the rule's purpose.

Because the approach may have been unwise does not mean that the policy underlying the marital deduction is

erroneous. But the marital deduction formula needs much greater revision than it received in 1954.

As a matter of ultimate social policy, it is hard to quarrel with the thesis that a man's estate and his earnings ought to be available to his spouse after his death without diminution for estate taxes. Perhaps this belief is an outgrowth and natural product of the community-property system itself. A wife shares and contributes to the building up of her husband's accumulations equally as much in a common-law jurisdiction as under community-property rules. And, if this is true, it seems unfair to reduce the amount of these accumulations to which she has contributed by way of a tax on her husband's death. For these reasons the policy of the marital deduction has much to commend it.

But can such a policy be implemented by a statutory framework that will achieve equalization? Perhaps. One method would be to provide a complete exemption from estate and gift tax for all interspouse transfers. This is a suggestion that has been made frequently in the past, and its adoption appears to be as remote as ever.

Another suggestion for improvement would be to adopt a series of amendments to the present marital deduction formula. The first of these ought to be to get rid of the qualitative restrictions on the types of transfer that qualify for the deduction. In other words, the terminable-interest rule, which has caused so much grief and misunderstanding, should be eliminated, if for no other reason than the fact that its restrictions can readily be avoided both in common-law and community-property jurisdictions.

Coupled with this relief must obviously be a provision designed to catch the property in the surviving spouse's estate if it is deductible in the decedent's estate. Under the existing rule which exempts a remainder interest from taxation in the life tenant's estate, the terminable-interest rule is essential in order to prevent wholesale tax avoidance. But if the rule is revised, or if a condition is attached to the deduction that the surviving spouse agree to report the value of the remainder in her estate, this difficulty would be eliminated. At any rate, an amendment of the rules relating to the taxation of life tenants must go hand in hand with any relaxation of the terminable interest rule.

Turning to the quantitative inequalities that presently exist under the marital-deduction formula, the best hope for equality lies in the correlation of the estate and gift taxes into one over-all transfer-tax pattern. In other words, gifts by living persons should be treated as part of a person's ultimate estate plan, which in many cases they really are. A tax would be levied on these gifts as a prepayment of the ultimate estate tax due.

Basically, an owner of common-law property should be permitted to transfer one-half of it to his spouse tax-free, whether the transfers are during life or at death. The available marital deduction would be exhausted either by inter vivos gifts or by bequests at death. To the extent that gifts during life had been made under the deduction, the amount of the deduction allowable at death would be correspondingly reduced.

And, finally, to accomplish complete equality, the deduction must be a function of the total estate of both spouses. The amount of the deduction would no longer be one-half of the decedent's adjusted gross estate; it would be one-half of the total of the decedent's estate plus his spouse's property. Any property owned by his spouse would reduce the amount of the deduction dollar for dollar, regardless of the source from which the property came. Only a formula based on the total holdings of both spouses can approach the philosophy behind the community system.

Whether or not these suggestions are of value and would provide a feasible and workable solution to the dilemma of equalization will depend upon the thought and criticism that can be brought to bear upon them. Perhaps the changes brought forward here would only serve to complicate even more an already-complicated problem. But, on the other hand, these suggestions may ultimately prove to be an acceptable solution to our present difficulties and complexities. Only further study and criticism can give the answer. ☆

New trusts & estates decisions

Income under new custodian laws can be taxable to one obligated to support. If securities are transferred to a minor under the model custodian act adopted by Colorado and other states, income from the property is taxable to the person obligated to support the minor to the extent the income is so used. The relationship of the donor or of the custodian to the donee is immaterial. Income not so used is taxable to the minor. [See comment, page 348. *Ed.*] *Rev. Rul.* 56-484.

Basis of assets of revocable trust is value at date of grantor's death. A grantor transferred stock in trust, reserving a life income and the right of revocation with the consent of one or both of the trustees. The court reasoned that for all practical purposes there was no completed gift; the stock belonged to the grantor until his death. Accordingly, the basis of the stock to the trust for purposes of gain on sale was the value at date of the grantor's death. *Beckman Trust,* 26 TC No. 147.

Decedent was trust beneficiary, not owner of property; estate taxable on distributable income. Although the tax implications of the question at issue are not clearly stated, it appears that the estate took the position that the decedent owned property outright, that when he died the property went to his wife and that she alone is taxable on the income. The Commissioner contended that decedent was the beneficiary of a trust which owned the property, that the income was distributable to the estate, and that the estate therefore owes tax. Apparently, the parties, all related, frequently dealt with the property as direct owners. However, the Tax

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Court holds the trust continued in existence and upholds the Commissioner. *Frothingham Estate,* TCM 1956-211.

Basis determined under gift rules, though donor retained some interest. Taxpayer was a beneficiary of an irrevocable trust of real property made in 1928, but the grantor had reserved a life interest and the right to change the named beneficiaries. When the grantor died in 1944, he had not changed the beneficiaries. The trust ended and distributed its property, the taxpayer receiving an undivided one-fifth interest. This interest he sold the following year. The Commissioner claimed that the basis of the property was the value at the date of death because the grantor retained control until then. The court holds that the Commissioner's argument is applicable to a revocable trust only. The 1928 transfer was an irrevocable gift, and the rules as to the basis of gift property apply. The basis for computing loss was basis in the hands of the grantor at the time he made the gift in 1928, even though the basis was less than the fair market value at that time. *Post,* 26 TC No. 135.

Beneficiary of discretionary trust taxable only on income distributed. Taxpayer was beneficiary of a trust, the income of which was payable to her in sole discretion of the trustee. She was taxable, the Tax Court holds, only on the amounts actually paid to her. This was the amount "distributable." *Owens,* 26 TC No. 7, *acq.* IRB 1956-37.

Beneficiary can deduct interest paid for trust; he had received corpus. The Commissioner contended that interest accruing on unpaid taxes of trust, prior to liquidation of the trust, were not deductible by the beneficiary who made the payment. The court allows the deduction as an expense incurred in the conservation of property. The unpaid taxes and interest of the trust are a lien against the assets distributed. *Norton,* DC LA, 9/28/56.

EXCESS PROFITS TAXATION: RECENT DECISIONS

Tax Court computation of EPT overassessment should ignore postwar refunds. The Tax Court previously determined taxpayer's constructive-average base-period net income. The parties could not agree on the computation of the resultant overassessment; specifically, they disagreed about whether the postwar refund of excess profits tax should be deducted in computing taxpayer's payments and newly-determined liability. The Tax Court is authorized to determine overpayments, though that term is not defined in the Code. Reviewing the mechanics of the postwar refund, it finds that the consistent way to compute an overpayment is to ignore the refund. *Journal Tribune Publishing Co.,* Rule 50 Decision, 7/9/56.

EPT relief case remanded to Tax Court; conclusion and facts inconsistent. This circuit court remands this case to the Tax Court for further consideration; the Tax Court had found that lack of productive capacity did not limit taxpayer's sales during the base period. This court says this conclusion is contrary to its own findings of fact. The facts indicated that additional machinery was not installed during the base period because of financial limitations. *Helms Bakeries,* CA-9, 8/14/56.

Reasonable base-period compensation of predecessor partnership determined for EPT credit. On remand from the Sixth Circuit, the Tax Court now determines a maximum of $17,000 as the proper amount to be subtracted in the base-period years as reasonable compensation to two partners of taxpayer's predecessor partnership. Under EPT, a corporation may use a predecessor partnership's income as its base period income but must subtract from it a reasonable salary for partners. This finding raises the excess profits credit so as to eliminate excess profits tax liability. *R & J Furniture Co.,* TCM 1956-204.

Pipeline company granted Section 722 relief. An oil pipeline company which commenced business during the base period is granted partial excess profits tax relief under Section 722. Its average base period net income is held to be an inadequate standard which could not be completely corrected by use of the growth formula. The company is permitted to increase its average base period net income by $40,000. *Rocky Mountain Pipe Line Co.,* 26 TC No. 140.

EPT relief because of change in character of business denied. Taxpayer, a printing company, claimed relief under Section 722(b)(4) because of a change in the character of its business during the base period. During that period, it claimed, there was a change in management and the acquisition of the business of a competitor. The court denies relief on the ground that the company failed to establish a constructive average base period net income sufficient to give it a credit in excess of the credit to which it was entitled under the invested capital method. *Hall Lithographing Co.,* 26 TC No. 144.

New installations in paper mill grounds for EPT relief. Taxpayer, a corporation operating a paper mill, installed a new filtration plant and new cone-type cookers during its base period. Because the changes directly resulted in a substantially higher level of normal earnings, the average base period net income is held to be an inadequate standard and a constructive base-period net income is determined under Section 722(b)(4). *Bergstrom Paper Co.,* 26 TC No. 146.

Change in character of business basis for EPT relief. As a manufacturer of poultry and livestock feed, taxpayer made several changes in the character of its business both during and immediately prior to the base period. It is now granted Section 722 relief. It established that if the changes in character had been made two years earlier it would have had at the end of the base period an earning level considerably in excess of its actual level. *Nutrena Mills, Inc.* 26 TC No. 141.

Normal base period earnings determined. Taxpayer, a canning corporation, claimed a constructive average base period net income under Section 722 of $58,000. It is allowed $18,000 as "normal earnings" in lieu of the $10,000 determined by the Commissioner of Internal Revenue. *Hanover Canning Co.,* 26 TC No. 142.

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NEW DEVELOPMENTS IN
Tax policy & legislation
FOR PRACTITIONERS

NAM disputes Butters: says high tax rates cause shortage of venture capital

When J. Keith Butters presented his opinion that high tax rates do not cause a shortage of venture capital to the Joint Committee on the Economic Report in December, he was basing his conclusion on a study made by him several years ago* which has since been widely regarded as the definitive work in this field. Mr. Butters is Associate Professor of Business Administration at the Harvard Graduate School of Business Administration.

The National Association of Manufacturers has issued an analysis of Mr. Butter's views, and of the study on which his recent statement was made. They find reasons why present tax rates may in fact be drastically inhibiting venture capital.

"Careful analysis of the Harvard [Butters] study," says the NAM, "has turned up five major defects in the report. These defects are so serious that those who are convinced that tax rates have created a venture-capital shortage should find, in the Butters paper, no reason for altering their belief.

"One of the principal points made in the Harvard study is that the investment capacity of upper-income persons is still very large, notwithstanding the extremely high income-tax rates of recent years.

"However, in reaching this conclusion, it incorrectly classifies capital gains as investment capacity. Also, it depends on a badly biased sample survey. While the paper states that accumulation of investable funds 'has been consistently large,' it has failed to study *business needs*, and thus is unable to make the expression 'large' a meaningful or useful term."

Following are the five major criticisms the NAM analysis made of the Harvard study:

1. The study assumes throughout that capital gains represent a form of income which is available for new investment in business.

An individual may use a capital gain to invest in a new venture. But some other individual was deprived of an equal amount of investment capacity in order to create this capital gain.

Hypothetically, consider the sale, by A, of a block of stock for $150,000 — which he originally had purchased for $100,000. It is bought by B with $150,000 he had accumulated by saving out of ordinary income.

The question is whether the $50,000 capital gain which A realizes represents a net increase in the funds potentially available for supplying new capital to business.

The answer is obvious. The capital gain does *not* represent such a net increase in new capital funds. In fact, there is some decrease in the amount of investable funds, since A must pay a tax on his capital gain. The $150,000 which B had accumulated out of ordinary income is now in the hands of A, but it did not increase in amount through the transfer. The $150,000 — less whatever amount A must set aside to pay the capital-gains tax — is available for new investment, but its origin is not in the capital gain, but in the process of saving out of ordinary income, by B.

2. The sample survey of "active investors" is seriously biased in the direction of showing upper-bracket individuals too favorable toward venturesome investments.

The survey was based on interviews with 746 selected persons. The smallness of the sample would not have been a serious defect had it been chosen so as to be a representative cross-section of the general population, or at least of upper-income persons whose capacity and willingness to invest are strategic for the supply of venture capital. But those interviewed were chosen from lists of people who maintained contacts with investment bankers and brokers.

In other words, an individual could not have been included in the sample unless he had shown sufficient capacity and willingness to invest to be considered a worth-while prospect for securities. Since the capacity and attitudes of individuals are the very question at issue, this cannot help but introduce a serious bias into the results. If an individual were so seriously affected by taxation as to destroy his ability or willingness to invest, his experience automatically was excluded from the sample.

3. The study does not include any investigation of business needs for capital which could be used as a criterion in judging the seriousness of tax effects on the supply of venture capital.

The seriousness of tax effects on the supply of capital cannot be judged in the absence of information on the need for capital. The only significant question is whether investment capacity is great enough to meet the needs of business, and the Harvard study is unable to answer this question.

4. Information collected on individual attitudes toward equity investments fails to take account of the fact that the effects of taxation, in creating a venture-capital shortage, have been discounted

A venture capital shortage originates in the inability or unwillingness of individuals to invest — but it manifests itself in the inability of business firms to sell their issues on terms they can consider acceptable.

There are always firms willing to issue securities even under adverse market conditions; securities which must be priced attractively. An individual might very well report a favorable attitude toward these particular new issues. His attitude does not alter the fact of a very real shortage of capital.

5. The basic investment objectives of individuals are assumed in the study to be inherent and unaffected by taxes. The result is to conceal any effects taxation may have in changing investment objectives.

The Harvard study divided the investors interviewed into five groups, according to their investment objectives, as: capital preservation; security and income; income; income and capital appreciation; and capital appreciation.

*Effects of Taxation: Investments by Individuals, by J. Keith Butters, Lawrence E. Thompson and Lynn L. Bollinger, Harvard Business School, Boston, 1953. $6.25.

NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

Knowing agent's methods, immunity rules, helps protect client being investigated

IT IS EXTREMELY IMPORTANT that the taxpayer and his adviser ascertain at the very beginning *who* is making the investigation on behalf of the Internal Revenue Service. There may be a great practical difference as to whether it is a revenue agent, or a Special Agent of the Intelligence Division, or whether it is a joint investigation by both.

It is also very important to determine whether the revenue agent is connected with the collection or audit division in the district director's office or is part of a separate unit in the director's office denominated "Fraud Squad," "Racket Squad," etc. These special squads dealing with fraud cases have from time to time been set up in the director's office in the large cities. At the moment it would seem that they have been discontinued, but they may come to life again at any time.

Normally, the revenue agent (assuming he is not connected with a unit specializing in fraud cases) is not primarily looking for a fraud situation. He may, however, stumble on to it, and if he considers it serious he will make a request through his group chief that a special agent of the intelligence division, also at the district director's level, take over the case.

Many times, of course, the special agent will initiate the investigation because of leads of many sorts which constantly pour into the Internal Revenue Service. Once the Special Agent is in the case he is in charge, and the function of the revenue agent if he stays on the case is to determine whether there is a tax deficiency and if so, to what extent.

What is the special agent looking for?

The sole function of the special agent is to evaluate the facts from the point of view of whether or not he ought to recommend that the taxpayer be proceeded against criminally. Therefore, schooled as he is in looking for evidence of criminal tax evasion, he must find substantial evidence to support a finding that there is a deficiency in tax and that there is proof of wilfulness.

As to the deficiency he may either seek evidence supporting proof of unreported income as to specific items or, failing to find such direct proof, he may seek indirect proof that there was unreported income even though he cannot link the proof to specific items. In the latter connection he, of course, resorts to indirect proof by way of net-worth increase, bank deposits, and cash expenditures, or any combination of these methods. Once having determined that there is proof of a deficiency, particularly if in a substantial amount, the special agent may slough off proof of wilfulness, working on the practical assumption that wilfulness will be inferred from the failure to disclose items of taxable income. Of course, if he finds evidence of concealment, misrepresentation, double sets of books, destruction of records, and other usual "badges of fraud" he will conclude that the omission of income must have been wilful.

The special agent is the one who makes the only recommendation as to penalties, whether they be civil or criminal.

Where do agents find evidence?

Normally there are four avenues open for locating proof of undisclosed income and the Treasury agents often develop proof in reverse order:

1. The original books and records of the taxpayer.
2. Admissions and confessions of the taxpayer, oral or written.
3. Secondary proof of the contents of the taxpayer's own books and records.
4. Evidence, oral or written, from third persons who have dealt with the taxpayer.

Especially where the investigating agents must resort to indirect proof of undisclosed income do they bear down heavily on evidence from third persons who can testify as to income-producing transactions with the taxpayer reflecting bank deposits, purchases, expenditures, etc.

The Secretary of the Treasury through his agents, called "delegates," is given the broadest powers to examine third persons and their books and records for the purpose of determining the correct tax liability of the taxpayer under investigation (1954 IRC Section 7602).

Internal revenue agents and special agents of the Intelligence Division may issue "summons" to third persons to appear before them for this purpose (1954 IRC Sections 7602(2) and 7603).

If the third person refuses or neglects to obey this "summons," the internal revenue agent or the Special Agent may obtain from the United States district court its order to punish for contempt (1954 IRC Sections 7604(a) and 7402(a)).

The 1954 Revenue Act consolidated and clarified substantially identical provisions which had appeared in the 1939 Revenue Code.

Third persons have no privilege

It is important to remember that a third person from whom information and records are sought respecting a taxpayer under investigation has no constitutional privileges to refuse to supply the information, as may be the case of the individual taxpayer himself.

Before the normal statute of limitations has run, barring assessments of deficiencies against the taxpayer under investigation, there is no limitation on the power of the Commissioner's agents to interrogate third persons other than that the investigation must be reasonable and relevant and not constitute an unfounded "fishing expedition."

After the normal statute of limitations for assessment and collection has lapsed, the right of the Commissioner's agent to examine a third person and his books and records is based on a reasonable showing that a fraudulent return was filed by the taxpayer.

The conditions of examination as to time, place, persons present, and extent of intended examination must all be reasonable; and the United States district court will not issue its order for

contempt unless it is satisfied that the conditions of the intended examination are reasonable.

Secondary proof

Where the taxpayer's own books and records are not made available, secondary proof of their contents may be resorted to by the Commissioner's agents.

If the government agent is able to take a good look at the contents of the taxpayer's books before the taxpayer decides to withdraw them from inspection, the agent may testify from recollection as to their contents.

Former employees of the taxpayer, such as bookkeepers, auditors, office managers, etc., may testify from personal knowledge as to the contents of the taxpayer's books and records.

As a practical matter, the availability of secondary proof gives the government a strong strategic weapon in the subsequent trial of an evasion case. The offering of such secondary evidence, which may not be very convincing standing alone, may result in "smoking out" the original books and records in the taxpayer's effort to contradict or explain away the government's evidence as to the contents.

Taxpayer's own books and records

We have seen in our discussion so far that by access to the records of third persons and by seeking secondary proof of the taxpayer's books and records, Treasury agents are in a position to do a great deal of their investigating before they even attempt to contact the taxpayer. This course of action may be resorted to by them for several reasons:

1. To supply some factual basis for weighing the taxpayer's truthfulness when he is ultimately questioned by the investigator.

2. To fortify themselves with proof in the event the taxpayer has altered, mutilated, or destroyed his records.

3. To obtain proof of the corpus delicti independent of the taxpayer's admissions.

4. To induce the taxpayer to talk and produce his records "voluntarily."

While the Fourth Amendment prohibiting unreasonable searches and seizures does apply to corporations, the Fifth Amendment against self-incrimination does not apply to *the corporate taxpayer.*

Nor does the Fifth Amendment apply to the officers of the corporation as to the corporate records, even if these records would incriminate the officer individually.

As to *the individual taxpayer* it is usually assumed that the Fourth Amendment protects him from unreasonable searches and seizures of his books and records and that the Fifth Amendment gives him the right to refuse to talk to the Treasury agents and to refuse to make his books and records available to them for inspection. Whether the individual taxpayer's rights under the Fifth Amendment have retained their historic vitality in the light of the decision of the Supreme Court of the United States in the case of *Shapiro v. United States* is a matter of serious concern.

To date the Department of Justice has not made any serious attempt to lean on the implicit holding of the *Shapiro* case that the self-incrimination privilege may not extend to the individual taxpayer, vis-a-vis, his own books and records on the basis that they are records required to be kept by virtue of the provisions of the Internal Revenue Code. Some day, however, the Supreme Court may be asked, squarely to decide that question.

These constitutional privileges are *personal* and must be asserted by the taxpayer himself. Unless he does so, they are waived. Neither his attorney, his accountant, nor his associates can assert these privileges in his stead.

These constitutional privileges *must be asserted* or they are waived. Constitutional privileges are not self-executory. They must be affirmatively asserted by the taxpayer at the very start of the investigation and he must continuously fight to establish them throughout the proceedings. As one judge has well put it: "The privilege against self-incrimination is neither accorded to the passive resistant nor the person who is ignorant of his right, nor one indifferent thereto. It is a fighting clause."

Unconscious waiver can be disastrous

If, during the investigation, either because of ignorance of his rights, or because of a desire to cooperate fully or as a result of the persuasiveness of the investigator, short of fraudulent misrepresentation or deceit, the taxpayer, with or without advice of counsel, answers questions or turns over his books and records for inspection, he has waived his immunities by not asserting them. He cannot later say that he misunderstood or was ill-advised or was not advised at all. He cannot ever call back what has already been divulged by him.

It is on this rack of waiver that most taxpayers later claim that they mistakenly, or without adequate understanding of the purpose of the investigator's activities, were broken. There is an increasing number of court decisions where taxpayers have attempted to keep the government from using damaging evidence obtained from them by revenue agents or special agents during the investigation. The government claims that the records were turned over "voluntarily"; the taxpayer claims that they were turned over to the agents on the assumption that only a civil liability was involved and that no criminal case was being made. While a few district court decisions have held for the taxpayer, the overwhelming majority of decisions of the appellate courts have held with the government on this score.

Part and parcel of the problem of whether under a particular set of facts a taxpayer has knowingly waived his constitutional privilege to refuse to turn over his books and records to the investigating agents is the question of whether or not there is a duty on the part of the investigator to warn the taxpayer of his constitutional rights or of the fact that if he finds sufficient evidence to justify such a recommendation he may recommend criminal action. The other side of the coin as to whether a *knowing* waiver of the taxpayer's constitutional rights has taken place is whether or not there is a duty on the part of the investigator to warn the taxpayer that he has the constitutional right not to talk or to turn over his books and records. Tied in with this duty to warn would be the related and implicit duty of the agent to advise the taxpayer that he is seeking evidence upon which to base a recommendation for criminal action. The majority judicial rule seems to be that as long as the revenue agent or special agent does not actually misrepresent his position he need not tell the taxpayer that there is a possibility that the agent may recommend criminal action. The fact that the taxpayer may be assuming that civil liability is all that is involved in the investigation would, therefore, be immaterial.

The investigator, however, cannot actively misrepresent or coerce a taxpayer. If he does, then the voluntariness of the taxpayer's waiver may be seriously questioned.

If the taxpayer stands on his constitu-

tional rights, he must refuse to comply with legal process if issued. Protection is not obtained by complying with legal process.

There are many statutes which provide that if a person produces books and records to investigating agents in response to a summons or a subpoena or legal process in exchange for the information thus obtained under process, which on constitutional grounds as we have seen he could otherwise have withheld, the person so producing records is granted immunity from prosecution on criminal charges directly related to the transactions reflected in his books and records. But in the absence of such a statute, it has been held that immunity from prosecution rests solely on the Fourth and Fifth Amendments subject to the rule of waiver.

It may, therefore, come as a surprise that this is exactly the situation which often arises during a tax investigation. The investigating agent, either as a bluff or seriously, may serve the taxpayer with legal process which could either be a "summons" to appear before him or a grand jury subpoena for the production of books and records. If the taxpayer succumbs to this ruse and complies with the legal process, even though accompanied by vehement protest, the taxpayer has thereby waived his constitutional rights.

If the taxpayer is to stand on his constitutional rights, he must refuse to comply with the process and refuse to surrender his books and records. The Treasury agent will then be placed in a position where he must either drop the attempt to commandeer the taxpayer's books and records or else cite the taxpayer for contempt. If the taxpayer stands pat and is cited for contempt, the district court will take evidence, including testimony from the taxpayer himself, and will decide for itself whether, if the taxpayer is ordered to produce his books and records, such action would incriminate the taxpayer.

The taxpayer cannot substitute his judgment on that issue for the judgment of the court. If the court holds that the taxpayer would incriminate himself by complying with the process, the books and records will not be obtained by the investigators, and for all practical purposes the danger of a criminal prosecution would be ended. If, on the contrary, the court holds that no incrimination will result from surrendering the books and records, the taxpayer either will have to comply, leaving the question of immunity to be raised later and to be decided by the court in the subsequent trial if criminal charges are brought, or the taxpayer will have to take the consequence of being punished for contempt.

It is well to keep in mind the rigors of the rules of law which seem to govern a situation where the taxpayer in compliance with legal process surrenders his books and records; however, in practice, except in the relatively rare instances where a particular agent overreaches in his zeal, if a subpoena or summons is issued to the individual taxpayer by a special agent or an internal revenue agent, it is a fairly clear sign that criminal action is not contemplated and that the books and records are being sought solely as a basis for arriving at the correct tax liability. But in what manner the taxpayer can assure himself of this being true before he turns over his books and records in response to the summons or subpoena is a question to which a satisfactory answer, applicable to every part of the country, can hardly be given.

Two other strategic moves to which the investigating agents may resort are (1) filing a Commissioner's return for the taxpayer under the provision of the 1954 Internal Revenue Code, Section 6020(b), and/or (2) processing a jeopardy assessment. Either one of these moves would harass the taxpayer to the point where he may be forced to show his hand, even though theoretically he would have a constitutional right to refuse to do so.

Privileged communications

During the lapse of time between the start of the tax investigation by Treasury agents and the trial of the taxpayer on evasion charges, if any are brought, many conferences and conversations may have taken place between the taxpayer and his attorney, between the taxper and his accountant, between the taxpayer and the Treasury agents, and between the attorney and the accountant. The likelihood of such conferences and conversations taking place raises many difficult problems of strategy and legal effect.

1. Communications between taxpayer and his attorney are privileged: limitations and shadow cast by decision *Falsone v. United States,* 205 F.2d 734 (5th Cir.) *cert. den.* It is, of course, a fundamental principle of our Anglo-American system of jurisprudence to encourage freedom of consultation between attorney and client; that which a client discloses to his attorney on the subject in issue, not in the presence of third persons other than those whose presence is indispensable, may not be revealed by the attorney if subpoenaed as a witness in subsequent litigation involving the matters communicated to him without his client's consent. Where the client is on trial on criminal charges, since the client's books and records in his possession could not be ordered produced at the trial, neither may the prosecution order the attorney to produce any books, records, or documents left in his custody by the client nor may the client be deprived of his privilege because the attorney either voluntarily or by inadvertence discloses the confidential communication to a third party not present at the time the communication was made by the client to his attorney.

But the privilege is a personal one and may be waived by the client. One of the surest ways of losing the privilege is for a third person, not the attorney's clerk or secretary, to be present when the communication takes place between client and attorney; this would destroy the privilege.

Having stated these broad principles, we should now concern ourselves with limitations which have been developed by the courts in the past few years.

The attorney has no right flatly to refuse to obey the special agent's "summons." He must show up and then stand on his privilege as to specific questions which affect the attorney-client relationship. While this qualification may be sound in law, it is questionable in practice because it would seem to indicate another way of "needling" the attorney who is representing a taxpayer in a fraud investigation.

If the attorney has simply acted as an agent for the taxpayer as, for example, where he has submitted a payment to Treasury agents in behalf of his client in an attempt to settle the case, he cannot refuse to testify about his transaction since an item of this sort is not clothed with the attorney-client privilege status. Nor is there a privilege as to testimony by the attorney as to monies handled by him on behalf of his client or as to property purchased by him for the client. Nor does the privilege extend to mere evidence of the attorney having acted as depositary of title or as having received money from

the taxpayer with which he bought real estate for the taxpayer.

If the attorney has the client's records in his possession but did not get them from the client but rather from the government or from the client's accountant, the attorney-client privilege is watered down to the point where the attorney may be ordered to give up the client's records under conditions.

And, of course, if the attorney with full authority from the taxpayer hands over the worksheets, records, etc., of the taxpayer to the investigators in the hope that this will explain away proposed deficiencies and avoid criminal charges, whatever privilege there was in the beginning has been waived.

Casting a shadow over the basic doctrine of attorney-client privilege is the obiter in the *Falsone* case to the effect that in any event the attorney cannot refuse to turn over to the government's agents the client's books, records, etc., in his possession because the client himself could not refuse to do so, for the reason that under the Internal Revenue Code and Regulations the client was compelled to keep these records. *Falsone* only reflected the shadow of *Shapiro* over the entire attorney-client privilege and, while certiorari was denied in *Falsone*, the government has not in practice pushed the doctrine of *Falsone* and *Shapiro* to its logical ultimate.

2. Communications between the taxpayer and his accountant are not accorded privileged status in federal tax proceedings, whether at the administrative level or the judicial level. This is true even in Colorado where a state statute establishes an accountant-client privilege. There is sound argument for the position that the attorney-client privilege ought to be extended to the accountant-client relationship. But in view of the doctrine of *Falsone* and cases following it, the likelihood of any change in the federal rule is remote.

The lack of privilege for communications between the client and his accountant has an enormously practical aspect since the accountant, being subject to divulging oral conversations with his client as well as the contents of the client's books and records, is one of the most damaging witnesses against his own client whom the government is able to find in a tax-evasion investigation. The cases are legion where the accountant, in an honest but often misguided effort to settle a tax controversy on a basis other than criminal charges, has nailed down the coffin in which his client is later buried by being forced to divulge incriminating evidence against his client.

A practical technique which may thwart the effect of lack of accountant-client privilege has been to have the attorney for the client hire the accountant as the former's agent or employee rather than to permit the client to hire the accountant. There is still a serious doubt as a matter of law whether this arrangement can bring to life a privilege status for the communications between the client and the accountant acting through the lawyer, and it is equally difficult to state whether there is a uniform practice in the Internal Revenue Service nationally toward recognizing a privileged status under this arrangement.

As the hybrid profession of accountant-lawyer continues to develop, we have an additional problem in the field of privileged communications: What is the status of such communication between the client and his adviser who is both an accountant and a lawyer?

The basic rule would seem to be that the privileged status of the lawyer will not be superimposed on the relation between the client and his adviser who is both lawyer and accountant merely because of that fact; rather the test will be whether the adviser was employed primarily for accounting work with legal advice being only secondary, or whether the situation was the other way around. At the administrative level, the situation would seem to be in flux, with no established national policy. ☆

Fraud cases reached new high during fiscal 1956

COMMISSIONER Russell C. Harrington recently reported that the Internal Revenue Service's stepped-up drive against would-be tax evaders established new records. During the 1956 fiscal year, the number of cases investigated, the number of cases in which prosecution was recommended, and the convictions obtained in cases reaching the Federal Courts soared to all-time highs.

Activities of the Intelligence Division resulted in 1,955 cases being forwarded to the Department of Justice, with recommendations for prosecution. Of this number, 762 cases involved wagering tax violations. During the 1955 fiscal period, 1,774 cases were forwarded to the Department of Justice.

In cases reaching the Federal Courts during the 1956 fiscal period, 1,372 defendants pleaded guilty or no defense, and 200 were convicted after trial. In 1955 fiscal, 1,210 defendants had pleaded guilty, and 129 were convicted after trial.

Commissioner Harrington said the Revenue Service would continue relentlessly its campaign against taxpayers who attempt to cheat on their obligations. ☆

Is officer criminally liable for false corporate return?

THE EXTENT of a corporate officer's criminal liability for a false corporate return has just been defined by the Third Circuit in the *Pechenik* case [see page 359, *Ed.*] In the trial court a jury had found the president of a corporation guilty of willfully attempting to evade the corporation's tax. Upon review, the Third Circuit reversed on the ground that the evidence did not support the verdict. In so doing, it pointed out what evidence was required and also indicated its concept of the executive's responsibility.

This area of possible criminal or civil fraud in dealings between corporate officers and the corporation is highly important and very difficult. The editor feels that the subject needs further discussion, and any comment or article which any knowledgeable practitioner might care to submit will certainly be welcomed.

Concerning the *Pechenik* case, here's what the court had to say.

"We are of the opinion that the evidence does not support the verdict, and that the defendant must be acquitted.

"The defendant was charged with wilfully and knowingly attempting to evade and defeat a large part of the taxes due and owing by the Colonial Products Company, a corporation of which he was president, for its fiscal years ending July 31, 1948, 1949, and ... 1950. The substance of the evidence,

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tax-wise, is that the income of the corporation for each taxable year was understated in its returns for the taxable years involved through the device of treating capital expenditures as operating expenses . . . .

"The defendant does not contend that the corporation's accounts and its tax returns were correct. He does contend that there did not exist on his part a willful and knowing attempt to evade taxes due, and that the Government did not succeed in adducing evidence of this statutory requirement, or evidence from which its presence could be inferred.

"The corporation, which was on the accrual basis, maintained a double-entry system of bookkeeping in which all of its business transactions were recorded. The books were kept consistently since September, 1946, by one Kehr . . . Kehr either made the entries or caused them to be made. He determined how the various expenditures should be entered on the books, and in general followed the same system throughout. The same certified public accountant, one Goldberg, since about 1940 or 1941, quarterly audited the corporation's books and annually prepared its income tax returns including those involved in this case. He did not, however, examine invoices, albeit a substantial amount of expenditures appeared unexplained in the "Purchases Sundry" column of the purchase journal. Apparently the accountant did not regard it to be within his duties to go behind the ledgers, and there is a dispute in the evidence as to whether his original employment was with the understanding that he would make only a "limited audit."

"When, in 1951, the Internal Revenue Service investigated the corporation's returns, the defendant instructed the accountant to make available all of the corporation's records. When it became evident that there were errors, he engaged other accountants and had the corporation's income taxes recomputed by them. The defendant at all times cooperated, both during the investigation and the trial of the case, with the various Governmental agents.

"The gravamen of the offense created by Section 145(b) is the willful attempt to evade or defeat the tax. . . . And in *Spies v. United States*, 317 U.S. 492, 499 (1943) that Court indicated in a general way various forms of deceitful practices, such as dual sets of books, false entries or alterations, destruction of books and records, concealment of assets or income, and the like, which bespeak the necessary evil intent. The conscious purpose to defraud proscribed by the statute does not include negligence, carelessness, misunderstanding or unintentional understatement of income. . . . Despite the efforts of the Government, the record fails to reveal probative evidence linking the defendant with the erroneous books and tax returns in any manner which should result in his conviction of the offense charged.

"The defendant, notwithstanding the business experience attributed to him, left the books, bookkeeping and preparation of tax returns to the bookkeeper and the accountant. There is a dispute on the record between the bookkeeper and the accountant as to whether the accountant showed the bookkeeper how to go about his job. There is no evidence that the defendant interfered with either of them or with the books. On the contrary, the invoices and payments were taken care of by the bookkeeper in the ordinary course of business and he made the decisions as to classification of expenditures according to his own best judgment. The bookkeeper testified that the defendant did not give him directions to charge an expense to one item of account rather than to another. The accountant prepared the corporation's tax returns from the books of the corporation, and defendant caused them to be filed. He did not attribute the errors to the defendant or to any directions or information given by the defendant. His explanation was that he did not examine the invoices, but these were available. Nothing was concealed. No information was refused.

"It is not suggested that either the bookkeeper or the accountant was a participant in the crime charged. It is suggested by the Government that it is incredible that the defendant did not know all along that capital expenditures were improperly treated; hence he knew the corporation's tax returns were false. This suggestion, however, does not arise from the evidence, but rather from unwillingness to believe that the evidence is true. Certainly the jury could accept or reject the testimony which exonerated the defendant of evil intent. But disbelief does not supply proof that the defendant participated in, directed or knew the books were kept incorrectly. . . . The Government places heavy reliance upon the claim that at one time the defendant told a bank official visiting the premises in connection with a contemplated loan that the cost of a warehouse had been charged off as an expense. The defendant testified he relied upon a statement made to him by the accountant. It is indeed incredible that such a completely frank statement of an erroneous procedure should be made to one interested in the good faith of those administering the corporate affairs if bad faith was the motive of the defendant. In any event, neither the statement nor anything in evidence permits the conclusions that defendant knew substantially all of the corporate capital expenditures were charged off as operating costs and that the defendant understood the procedures employed by the bookkeeper and accountant were inadequate and erroneous.

Conclusion

"We are left with the firm conviction that what the Government established here is a case of mistake and such mistake, standing alone, is not sufficient to sustain a conviction. . . .

"Here the direct evidence does not establish a willfulness, knowledge of falseness and intent to evade taxes on the part of the defendant. Moreover, nowhere does the evidence disclose the positive type of conduct on the part of the defendant indicated by the Supreme Court in *Spies v. United States, supra*, as necessary to the felony specified by Section 145(b). Speculation and intuition cannot be substituted for proof. That is so even on the civil side in tax cases where the burden of proof upon the Government is less than that which prevails in criminal tax cases. Moreover, this court and others have already made it clear that reliance upon the conduct of employees in good faith, is not a punishable event. . . ."

"Sentence reversed and cause remanded." ☆

Certiorari granted in 3 famous tax fraud cases

THE U. S. SUPREME COURT has agreed to hear appeals of conviction for fraud for evasion of income tax of Henry W. Grunewald, Daniel A. Bolich, and Max Halperin. All three defendants achieved considerable noteriety during and prior to their trials.

Grunewald has been described as a "five percenter," or peddler of influence in government circles; Bolich is a former Assistant Commissioner of Internal Revenue, and Halperin is a New York attorney.

Each was sentenced to five years, and fined $15,000, $10,000, and $8,000 respectively.

At the time of the *Grunewald* circuit court decision, we reported [5 JTAX 161] that the dissenting judge said that there "should be a new trial because of an error in the judge's charge concerning the statute of limitations. The statute as to conspiracy is three years and as to prosecution for tax evasion, six years. The judge charged that the conspiracy ended more than three years prior to the indictment unless an integral part of the conspiracy was an agreement to conceal the acts of the conspirators. But such a charge could suspend the statute of limitations in conspiracy cases indefinitely by an act of concealment at any time if the jury found that the mere exisence of a conspiracy implies an agreement to conceal it. If the judge had charged properly, the jury might have inferred that the acts of concealment were done, at least in part, to prevent prosecution for tax evasion. Such acts would have fallen under the six-year statute."

What the Supreme Court does in these cases will be a matter of great interest to the nation as well as to tax practitioners. ☆

NEW DECISIONS IN FRAUD & NEGLIGENCE THIS MONTH

Conviction based on net worth upheld. Taxpayer alleged error in his conviction for tax evasion. He claimed he had over $70,000 cash in a safe-deposit box on December 31, 1944, and not $50,000 as the Government contended. He also claimed that $20,000 of the Government bonds in his possession had been purchased by his mother. This court reviews the evidence and finds it sufficient to justify the jury verdict. *Glender*, CA-9, 9/24/56.

Taproom operator's omission of income fraudulent. An operator of a taproom business also received income from rents, salary, and investments. His failure to keep adequate books and records is held to justify resort to the net-worth method to determine tax deficiencies. Penalties for fraud and substantial underestimation of tax are sustained. *Scott*, TCM 1956-220.

No appearance; deficiencies and fraud upheld. Where there was no appearance at the hearing by or on behalf of taxpayer, the court sustains the deficiencies and fraud penalties. *Sager*, TCM 1956-225.

Gambler taxable on unexplained deposits. Taxpayer operated a trucking business and was also a member of a gambling partnership. He had filed no tax returns and maintained inadequate records. Although he contended that he sustained losses and that no tax liability existed, the Tax Court holds that the Commissioner properly reconstructed income from admitted trucking receipts, unexplained deposits, known gambling income and proved expenses. Additions to tax for failure to file returns are upheld, but the fraud penalty is not sustained. That taxpayer did not prove error in the Commissioner's inclusion of unexplained deposits in income will not support the fraud penalties. *McCormack*, TCM 1956-216.

Jury finds tenant farmer's understatement of income not fraud. For the years 1942, 1943, 1944, the Government assessed about $9,000, including penalties and interest. Contending that taxpayer had unreported income from whisky sales, the Government reconstructed taxpayer's income by the net-worth method. Taxpayer claimed that she had little experience, limited education, and no knowledge of the tax laws, and that she had consulted an accountant who had prepared her returns on the basis of the information she gave him. The jury finds that the Government's net-worth computation has certain errors and that taxpayer is not guilty of fraud. *Grantham*, DC *Tenn.*, 5/22/56.

Gambler's income determined by net-worth method. Resort to the net-worth method to determine the income of taxpayer is held proper; taxpayer, who was engaged in the check-cashing business as well as illegal gambling, kept no permanent books and records from which his gambling income could be determined. Adjustments were made to the Commissioner's net-worth analysis to correct inaccuracies. The penalty for substantial underestimation of tax is sustained. *Feingold*, TCM 1956-214.

Reverse conviction of president for corporate fraud; no proof he had knowledge. The defendant was the president of a corporation which erroneously charged capital expenditures to expenses. The bookkeeper had kept the books without interference or instructions from the corporation's president, and he had determined the classification of expenditures. A CPA had prepared the income tax return from the books, without examining the purchase invoices. The court reverses the conviction. There is no proof, it holds, of the president's knowledge of or intent to evade taxes. [See comment, page 357] *Pechenik*, CA-3, 9/18/56.

"Wages of sin" subject to tax. A prostitute who kept a house of prostitution filed no returns and kept no books or records of her income-producing activity. The Commissioner was held justified in computing her income by the net-worth method. Fraud penalties are assessed against the taxpayer because of the willful omission. *Lane*, TCM 1956-209.

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TAXATION OF

Partnerships

EDITED BY JACKSON L. BOUGHNER, LL.B., CPA

ABA Tax Section points out many difficulties practitioners are having with partnerships

TAX MEN continue to have trouble with the partnership provisions of the new Code. Agreement is widespread that Subchapter K is as tough and uncertain to work with as any in the law. Taking its cue from the seriousness of some of these difficulties with present taxation of partnerships, the committee on partnerships of the Section of Taxation of the American Bar Association has undertaken an exhaustive analysis of the workings of Subchapter K.

The committee, of which Arthur B. Willis, of Los Angeles, is chairman, and your editor is a member, points out how these difficulties arise. In the following summaries of the committee's work are revealed not only the need for revision of the Code, but an excellent insight into technical considerations faced by the practitioner in planning his client's partnership tax affairs.

While the first four of the recommendations have been approved by the Section and the fifth recommitted for further study, the technical analysis which follows is presented more for its substance than for a report on official Bar Association action.

Gross income of a partner

The Code should be amended to provide that in determining the gross income of a taxpayer from a partnership of which he is a member, there shall be taken into account only the excess of his distributive share of the gross income of the partnership over any guaranteed payments from the partnership that are included in his gross income. This result could be achieved by amending Section 702(c), effective for taxable years ending after the date of enactment, to read: "(c) GROSS INCOME OF A PARTNER.—In any case where it is necessary to determine the gross income of a partner for purposes of this title, such amount shall include *the excess* of his distributive share of the gross income of the partnership *over any payments from the partnership that are included in the partner's gross income under sections 707(c) and 61(a).*"

Section 702(c) now provides that in any case where it is necessary to determine gross income of a partner, such amount shall include his distributive share of the gross income of the partnership. Section 707(c) provides that guaranteed payments of salary or interest to a partner shall be considered as made to one not a partner for certain limited purposes including determination of the partner's gross income under section 61(a). Since guaranteed payments to a partner do not reduce the partner's distributive share of such income, there will be a double inclusion in the partner's gross income because of the overlap of guaranteed payments and his distributive share of gross income from the partnership. The proposed change in section 702(c) will prevent this unintended result.

Death of partner and close of year

Section 706(c) should be amended to permit the executor or administrator of the estate of a deceased partner to elect whether the deceased partner's share of partnership income to date of death shall be included in the decedent's final return or whether the partnership year shall continue with respect to the deceased partner.

Section 706(c) provides as a general rule that the taxable year of the partnership shall not close as the result of death of a partner, the entry of a new partner, the liquidation of a partner's interest, or the sale or exchange of a partner's interest. The purpose of section 706(c) is to avoid a bunching of income in the year of a partner's death or in the event of certain other changes in the membership of the firm.

The statutory provision goes further than is required. In the absence of a bunching of income in the final return of the deceased partner, it may be desirable to close the taxable year of the partnership with respect to that partner and to permit his share of partnership income to be reported in his final return. The deceased partner may have deductions and exemptions which could be offset against his share of partnership income if included in his final return and which may be lost if the partnership year does not end with respect to the deceased partner as of the date of his death.

The regulations (Section 1.706-1(c)(3)(iv)) attempt to remedy this situation in part by providing that if there is an agreement for sale or exchange of a deceased partner's entire interest as of the date of his death, the taxable year of the partnership closes as of that date. The regulations do not fully cure the situation and it appears that legislation is required.

Under the proposed amendment to the statute, the general rule would be that the partnership year closes with respect to a deceased partner as of the date of his death. This probably is the result that would be expected by the average taxpayer and it is for that reason that it is stated as the general rule. However, the executor or other successor in interest of the deceased partner may file an election to continue the taxable year of the partnership with respect to the deceased partner. Further, if the interest of the deceased partner is sold or liquidated as of the date of his death, pursuant to a binding agreement, the taxable year of the partnership closes with respect to the deceased partner at whichever is the later of:

1. The date of sale, exchange or liquidation of the interest of the deceased partner, or

2. The day following the death of such partner.

The general rule in Section 706(c)(2)(A) of the present law is that the partnership taxable year closes with respect to a partner who sells or exchanges his entire interest or whose interest is liquidated. This could result in a bunching of income in the final return of a deceased partner if the partnership agreement provides for the sale or liquidation of his interest, pursuant to a binding contract, as of the date of his

death. There is no policy reason for closing of the partnership taxable year so as to require reporting of the deceased partner's share of his income in his final return. Under the proposed amendment, if the successor in interest of the deceased partner so elects, the taxable year of the partnership will close with respect to a deceased partner on the day following his death, notwithstanding the sale or liquidation of his interest as of the date of his death.

Termination sale of 50% interest

Section 708(b)(1)(B) should be amended to provide that a partnership is terminated by a sale or exchange of an interest of 50 per cent or more in partnership profits only if such interest is sold to others than partners.

This section provides that a partnership shall be considered as terminated if, within a 12-month period, there is a sale or exchange of 50% or more of the total partnership capital and profits. There is no sound policy reason for terminating the partnership where the interest is sold to other members of the partnership, and such a result creates an artificial distinction between a sale of an interest to such partners and a retirement of a partnership interest by distributions from the partnership in liquidation of that interest (Section 1.708-1(b)(1)(ii) of the Regulations). Accordingly, it is proposed that paragraph (B) of Section 708(b)(1) be amended to restrict its application to a sale, or to cumulative sales over a period of 12 months, to others than partners. To prevent misuse of this section, the partners to whom the interest is sold must have been partners for at least 12 months.

This amendment would facilitate clarification of a doubtful point of interpretation under present law. The regulations Section 1.708-1(b)(1)(ii)) state that the contribution of capital to a partnership does not constitute a sale or exchange of a partnership interest for the purpose of applying Section 708(b). This is a correlative of the provision in the regulations that the liquidation of a partnership interest is not a sale or exchange for the purposes of Section 708(b). Under the existing law both provisions are justified as affording relief from the harsh statutory rule that the sale of a partnership interest to other members of the firm could cause a termination of the partnership. The proposed amendment eliminates the necessity for providing this relief. Under the proposed new statutory rule, it would appear completely appropriate for the Congressional committee reports to indicate that the Congress intended a liquidation of a partner's interest or a contribution of capital by a new partner to be considered a sale or exchange for the purposes of Section 708(b).

The present law is confusing in that it speaks of "a sale or exchange" occurring "within a 12-month period". Obviously a cumulative concept was intended so that if all sales or exchanges within the 12 months resulted in a total sale or exchange of 50 per cent or more of the interest in capital and profits, the partnership would be terminated. Changes in the language of the present statute are proposed in order to clarify this concept.

Termination of a two-man partnership

We should permit a partnership composed of two persons to continue subsequent to the death or retirement of one partner, provided that during such period payments that qualify under Section 736 are made to the retiring partner or to the successor in interest of the deceased partner.

Section 708(b)(1)(A) provides that a partnership shall be considered as terminated if no part of any business, financial operation or venture is carried on by any of its partners "in a partnership." This creates a difficult problem in the case of a two-man partnership where one partner retires or dies with the result that the business is thereafter conducted by the survivor in a proprietorship form. The regulations attempt to solve the problem by providing (Section 1.736-1(a)(6)) that if payments are made to a retiring or deceased partner which qualify under Section 736, the partnership is considered as continuing so long as such payments are made. Because the regulations may exceed the statutory authority, the proposed change would incorporate the rule in the statute.

Transfer of interest for services

Section 721 provides that no gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to a partnership in exchange for an interest in the partnership. The regulations (Section 1.721-(b)(1)) provide that Section 721 does not apply to the extent that an interest in partnership capital is obtained by a partner as compensation for services and not in exchange for his contribution of property to the partnership. This latter rule seems consistent with good policy and is supported by decisions of the courts dealing with stock issued for services. However, the question has been raised whether this provision in the regulations is valid. The point is of such significance that the statute should be amended to provide specifically that the partner receiving a capital interest in exchange for his services must include the value of that capital interest in his gross income as compensation for services.

There is an exception to the application of Subsection (b) which requires inclusion in taxable income of the fair market value of a capital interest received as compensation for services. This exception applies to the extent that the capital interest transferred represents an interest in the partnership's mineral properties, for the development of which the capital interest was transferred to the service partner. The exception is intended to conform the partnership provisions with existing rulings and case law in the treatment of interests acquired directly in mineral properties. Consequently, the same operation will prevail whether the development of the properties is in a partnership operation or by an arrangement that does not constitute a partnership.

If a partner receiving the capital interest is required to include the value of such interest in his gross income as compensation, the other partners should be allowed a deduction for the value of the capital interest transferred. The proposed amendment allows such a deduction, providing the circumstances would permit allowance of the deduction if payment for the services were made in money. The allowance of the deduction to the other partners also requires a provision to treat the transfer of the interest to the service partner as a sale or exchange of portions of the capital interests of the partners who transferred some of their interests.

The capital interest acquired by the compensated partner may have substantial conditions or restrictions on its withdrawals or disposition. Such conditions or restrictions affect the time of realization of income and also the fair market value of the property received. It is contemplated such restrictions and conditions are to be taken into account, under the proposed amendment, in de-

termining the time and amount of income realized from receipt of a capital interest in a partnership in consideration for services. Since paragraph (3), dealing with the deduction allowed to the other partners, is dependent upon the amount of income taxed to the service partner, the conditions and restrictions on the capital interest transferred will also affect the amount and time of the deductions allowed to the other partners.

Gain or loss on disposition

If a taxpayer who has received a distribution of property from the partnership gives or otherwise transfers such property in a transaction where the basis of the transferee is determined in whole or in part by reference to the basis of the distributee partner, the transferee should likewise be subject to the provisions of Section 735.

Section 735 provides in effect that if a partnership distributes unrealized receivables or inventory items to a partner, the gain or loss realized by that distributee partner upon a subsequent sale or exchange of such unrealized receivables or inventory items will be ordinary income. The section by its express language applies only to the gain or loss on the disposition of property "by a distributee partner." Thus, if the statute is literally applied, a distributee partner could make a gift of the unrealized receivables or inventory items received by him as a distribution from a partnership, and the donee would escape application of the provisions of Section 735. It is proposed that Section 735(a) be amended to apply also to a sale or exchange of such unrealized receivables or inventory items by a taxpayer who acquired them from the distributee and whose basis for such property is determined by reference to the distributee's basis.

Payments to a retiring partner

Payments to a retiring partner or to the successor in interest of a deceased partner should be permitted to qualify under Section 736(a) only if either such payments are made in money and in more than one taxable year of the partnership, or the parties agree that such payments are to constitute Section 736 (a) payments.

The proposed Regulations (Section 1.736-a(2)) provided that payments qualifying under Section 736(a) must be made in money and that such payments must be made in more than one taxable year of the partnership. The final Regulations contain no such requirement, presumably because of the lack of statutory authority. The statute should contain requirements, similar to those in the proposed regulations, in order to prevent unexpected and undesirable tax consequences.

For example, the A-B-C partnership agreement provides for payment of $50,000 for the interest of a deceased partner in the partnership. Payment is to be made in cash within 90 days after death. Liability for the payment is funded with life insurance. The partnership agreement makes no reference to a payment for a deceased partner's interest in good will. Partner C dies and the continuing partnership of A and B makes the $50,000 payment to C's executor in full retirement of C's interest in the partnership. If it is later determined that the fair market value of C's interest in partnership property (exclusive of good will) was $30,000, C's estate would have ordinary income of $20,000, representing a payment under section 736(a). The taxable income of A and B would be reduced by $20,000, a fact that might influence their ideas with respect to the valuation of C's interest in the partnership property.

If there is a lump sum payment for the interest of a retiring partner or deceased partner, or if the interest is retired by a distribution of property other than money, it is probably the usual intention of the parties that the transaction be considered a capital transaction rather than an income distribution. Accordingly, it is proposed to amend Section 736(a) by adding a new paragraph (2) dealing with limitations on the treatment of a payment as a distribution of income or a guaranteed payment. Under the first limitation, the payment must be made in money and payments must be made in more than one taxable year of the partnership.

However, if the parties clearly intend a lump sum payment or a distribution of property other than money to be a distribution of income, and assuming it otherwise qualifies, there is no apparent policy reason why such payment or distribution should not be treated as a Section 736(a) payment. Accordingly, in paragraph (2) there is an alternative limitation that would recognize a lump sum payment or a distribution of property as a Section 736(a) payment if the parties so agree, and if the payment or distribution otherwise falls wihin Section 736(a). Regulations to be prescribed by the Secretary or his delegate will specify what evidence is required of the existence of such an agreement.

Income of a deceased partner

Section 743(b) should be amended to provide that no adjustment may be made under Section 743(b) to the basis of unrealized receivables of the partnership as the result of death of a partner; that Section 753 be broadened in its definition of income in respect of a decedent in the case of a deceased member of a partnership; and that Section 1014(c) be amended with respect to basis of a deceased partner's interest in a partnership which has unrealized receivables.

It is very possible that the present statutory provisions could be interpreted so that a successor in interest of a deceased partner is entitled to an adjustment to basis of unrealized receivables of the partnership under Section 743(b), assuming a proper election is made under Section 754. There is nothing in Section 743(b) that specifically denies the right to adjust basis of unrealized receivables in the case of a transmission of a partnership interest upon death of a partner. The fact that Section 753 is restricted to payments qualifying under Section 736(a) tends to indicate the absence of any limitation on the adjustment to basis of unrealized receivables of a partnership.

Assume that the A-B-C partnership has unrealized receivables of $30,000 at the time of A's death. If the partnership makes payments to A's successor in interest for his interest in the partnership, Section 736(b)(2)(A) requires that the payments for A's $10,000 interest in unrealized receivables shall be treated as payments under Section 736(a). Section 753 defines such payments as "income in respect of a decedent." The payments in retirement of A's interest in the unrealized receivables are ordinary income to A's successor in interest and reduce the partnership income taxable to B and C. If, however, the partnership should file an election under Section 754 to adjust basis of partnership property, pursuant to Section 743(b), to reflect the transmission of the partnership interest to A's heirs, then A's successor in interest could claim that under Section 743(b) there should be a $10,000 adjustment to basis of unrealized receivables. This adjustment would be

confined in its effect to A's successor in interest. Thus, by continuing the partnership and filing the election under Section 754, A's successor in interest completely avoids the realization of taxable income with respect to A's interest in unrealized receivables as of the date of his death. B and C would be willing to go along because they are taxed on $20,000 of ordinary income either way.

If the adjustment to basis under Section 743(b) can be made to unrealized receivables of the partnership, A's successor in interest could also avoid the realization of income with respect to A's share of unrealized receivables through a sale or exchange of A's partnership interest. Section 751(a) would still be applicable, but there would be no taxable gain attributable to the sale of A's interest in the unrealized receivables.

To close these loopholes in the statute, Section 743(b) should be amended to provide specifically that no adjustment may be made to the basis of unrealized receivables upon the death of a partner. Section 753 should be broadened so that such unrealized receivables fall within the definition of income in respect of a decedent. Section 1014(c) should be amended to make it abundantly clear that the amount which is considered income in respect of a decedent under Sections 753 and 691 is not included in the basis of the partnership interest of a deceased partner.

Sale or exchange of interest

In the case of a sale or exchange of a partnership interest, the gain or loss of the transferor partner attributable to unrealized receivables and to substantially appreciated inventory should be determined as though the partnership had sold the unrealized receivables or appreciated inventory and the transferor partner shall be taxed on his distributive share of the gain attributable to the unrealized receivables or appreciated inventory.

Section 751(a) provides in effect that an allocation shall be made of a portion of the sales price of a partnership interest to unrealized receivables or substantially appreciated inventory. The regulations (Section 1.751-1(a)(2)) require that basis of the interest sold in the Section 751 property shall be determined as though such property had been distributed to the transferor partner immediately prior to the sale or exchange of his interest in a pro rata distribution. This formula for determining gain or loss on sale of a partnership interest allocable to unrealized receivables or appreciated inventory items is extremely complicated in practical application.

It is recommended that Section 751(a) be amended in several particulars. In order to facilitate the legislative language, it is proposed that there be a definition of the term "Section 751 property." The regulations at Section 1.751-1(a)(1) adopt this approach and define section 751 property as including unrealized receivables and substantially appreciated inventory items. This definition is found in Section 751(a)(4), as proposed to be amended.

It is also proposed that Section 751(a) be amended to provide that the gain or loss of the selling partner attributable to the sale or exchange of his interest in Section 751 property shall be determined as though the partnership had sold such Section 751 property at market value. It is contemplated that the actual sales price of the partnership interest will be used in determining the sales price at market value. This would prevent the use of a theoretical market value of the Section 751 property that does not take into account the valuation used by the parties in fixing the sales price of the partnership interest. The proposed statutory amendment is designed to also cover the situation where a partner sells less than his entire interest in the partnership.

What the Regulations say

Section 751(a) does not provide for the sale or exchange of an interest in a partnership having Section 751 property where the transferor partner acquired his interest by a transfer within 2 years prior to the date of such sale or exchange but the election under Section 754 is not in effect. The Regulations at Section 1.751-1(2) attempt to cover this situation by providing that the transferor partner's basis of the Section 751 property "shall be an amount equal to the basis such property would have had under Section 732 (including subsection (d) thereof) if the selling partner had received his share of such property in a current distribution made immediately before the sale." By bringing into account the Section 732(d) adjustment, the regulations do achieve the effect of the adjustment to basis of partnership property under Section 743(b) that would have been made had the election under Section 754 been in effect. Paragraph (3) of Section 751(a), as proposed to be amended, incorporates a provision

AUTHORS OF THIS STUDY

CHAIRMAN of the committee on taxation of partnerships of the Section of Taxation, American Bar Association, which made this study, is Arthur B. Willis, of Los Angeles. Meade Whittaker of Birmingham, Alabama, is vice chairman. Fourteen subcommittees divided the task among them. Subcommittee chairmen are:

- Partner's Distributive Share, George Stinson, New York, N. Y.
- Taxable Years of Partners and Partnership, Leonard Cohen, Beverly Hills, California.
- Transaction Between Partner and Partnership, William L. Zimmer III, Richmond, Virginia.
- Basis Problems, Crane C. Hauser, Chicago, Illinois.
- Distribution of Partnership Property, Loyal E. Keir, Des Moines, Iowa.
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- Optional Adjustment to Basis of Partnership Properties, Charles P. Cobb, Memphis, Tennessee.
- Unrealized Receivables and Appreciated Inventory Items, Mrs. Carolyn K. Tenen, N. Y., N. Y.
- Miscellaneous Points, F. Edward Little, Los Angeles, California.
- Application of Partnership Tax Provisions to the Oil and Gas Industry, Joseph P. Driscoll, Washington, D. C.
- Unincorporated Associations Electing to be Taxed as Corporations, George L. Cassidy, Detroit Michigan.
- Partnership Problems Involving Other Committees of Tax Section, Meade Whitaker, Birmingham, Alabama.
- Taxation of Law Partnerships, Jackson L. Boughner, Chicago, Illinois.

that corresponds to the relief afforded by Section 732(d).

Substantially appreciated inventory

The Code should be amended to provide that inventory items will be considered to have appreciated substantially in value only if (1) such appreciation is more than 20 per cent of the appreciation in value of all partnership properties that have appreciated in value, and (2) the fair market value of the inventory exceeds 120 per cent of the total net worth of the partnership determined by using fair market values for partnership properties.

Substantially appreciated inventory items are defined in the present statute as inventory items the value of which exceeds 120% of the partnership's adjusted basis of such property and 10% of the fair market value of all partnership property other than money. It is possible to avoid the 120% test by planned action, such as causing the partnership to purchase additional inventory having a market value no greater than cost. It is also possible to avoid the 10% test by causing the partnership to use its cash to purchase securities, or to borrow money to purchase securities, or to otherwise "juggle" assets and liabilities.

To make the test of substantial appreciation more meaningful and less vulnerable to planned tax avoidance, it is proposed that substantially appreciated inventory be determined by a comparison between the appreciation in value of the partnership's inventory and the total appreciation in value of all of the partnership's property, whose fair market value exceeds adjusted basis. Thus, assume a partnership had inventory with a fair market value of $35,000 and an adjusted basis to the partnership of $20,000. The excess of fair market value over basis is $15,000. The partnership also has properties X and Y with bases and fair market values as shown in Table I.

TABLE I

	Adjusted Basis	Fair Market Value
Property X	$ 50,000	$140,000
Property Y	80,000	30,000
Total	$130,000	$170,000

For the two items the total excess of fair market value over adjusted basis is $40,000. However, the excess of fair market value over adjusted basis with respect to Property X is $90,000. Under the proposed amendment, Property X would be considered in the measure of whether the inventory was substantially appreciated. Property Y would be omitted from consideration. The computation would be as shown in Table II.

TABLE II

	Market Value	Adjusted Basis	Excess of Market Value Over Adjusted Basis
Inventory	$ 35,000	$20,000	$ 15,000
Property X	140,000	50,000	90,000
Property Y	30,000	80,000	....
Total			$105,000
Ratio to total of excess of market value			14%

The excess of market value over adjusted basis of inventory is less than 20% of the total appreciation (i.e., excess of market value over adjusted basis of partnership property) of those partnership properties that reflect an appreciation in value. Consequently, the inventory, in this example, is not substantially appreciated in value.

In addition to the inventory being substantially appreciated under the foregoing test, it also must have a market value that exceeds 120 per cent of the excess of the market value of all partnership property over the partnership liabilities. This is to avoid the problems of fragmentation where the appreciation in value of partnership property is insignificant in comparison with the total net worth, at market value, of the partnership. The measure is made the excess of market value of partnership property over partnership liabilities, rather than merely the market value of partnership property as in the present law, so as to eliminate obvious opportunities of increasing the partnership's property through borrowings.

Definition of inventory items

Section 751(d)(2)(B) of the present statute includes in the definition of inventory items any other property which on sale or exchange by the partnership "would be considered property other than a capital asset and other than property described in Section 1231." This definition probably is considerably broader than the Congress realized. Among the items which are not capital assets and not property described in Section 1231 (and consequently would be inventory items) are:

1. Real property or depreciable property used in the trade or business but which has been held for a period of six months or less (Section 1221(2)), and

2. Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of inventory (Section 1221(4)). This would include accounts receivable of an accrual basis partnership even though the amount realized on sale of goods or for services rendered has been included in the partnership's taxable income.

The inclusion of these items in inventory gives a distorted result which may work to the detriment of either the Treasury Department or the taxpayer. It is proposed to amend Section 751(d)(2)(B) so as to specifically exclude from classification as inventory items accounts or notes receivable acquired in the ordinary course of trade or business, Section 1231 property and real property or depreciable property used in the trade or business of the partnership but which has been held for a period of 6 months or less.

It will be noted that the proposed statutory language refers to property "with respect to which the amount realized on a sale or exchange by the partnership would be considered as an amount realized from the sale or exchange of property other than a capital asset." This language was designed with the thought of preventing the contribution to a partnership of Section 306 stock or of stock in a collapsible corporation (Section 341). Under the present statute, it might be possible to argue that such stock is not inventory as defined in Section 751(d)(2)(B). It is believed that the suggested language is broad enough to include Section 306 stock or stock of a collapsible corporation in the definition of inventory.

Under Section 751(d)(2)(C) of the present law, inventory items also include property which may not be held as inventory or for sale in the ordinary course of the partnership business but which would be so held if owned by the selling partner or the distributee partner. Presumably this provision is in-

tended to prevent dealers in real estate avoiding ordinary income consequences by participating in partnerships which hold real property for investment purposes.

However, in the case of a distribution of partnership property to which Section 751(b) applies, Section 751(d)(2)(C) may have unexpected and unfair consequences to some partners. For example, the A-B-C partnership holds real property which is a capital asset of the partnership. The partnership has no property other than the real estate and cash. If the real estate is distributed to A, who is not a dealer in real estate, it would not be an inventory item of the partnership and consequently Section 751(b) would not be applicable. However, if the real estate is distributed to C, who is a dealer in real estate, it would be an inventory item under Section 751(d)(2)(C) of the present statute. If the real estate had substantially appreciated in value, A and B would realize ordinary income under Secton 751(b), to the extent of their shares of the appreciation, as a result of the distribution of the property to C.

The proposed change in the statute would result in classifying property as inventory, by reference to its status if held by the distributee partner, only as to property owned by the partnership after the distribution. If property is distributed, the distributee partner, in effect, has reduced his interest and hence sold or exchanged his interest in the property remaining in the partnership. He realizes ordinary gain or loss if such property, in which he has reliquished or reduced his interest, would be inventory if held by him. On the other hand, if the property in question were distributed to such partner, so that the remaining partners are in effect selling or exchanging their interests in such property, the continuing partners only realize capital gain or loss since it is a capital asset to them.

Limiting partner's distributive share

Section 752, limiting the allowance of the share of a partner's losses in excess of the adjusted basis of such partner's partnership interest should be amended to permit the allowance of such share of such losses where the partner is unconditionally obligated to the partnership therefor.

Under the present provisions of Section 704(d), the excess of a partner's share of losses over the adjusted basis of his partnership interest is deductible only in the year in which such excess is repaid to the partnership. In determining his adjusted basis, any increase in his share of liabilities to third parties is taken into account so the partner may deduct his share of a partnership loss to the extent he becomes liable to partnership creditors. However, no logical distinction can be drawn between a liability of a partner to the partnership and a share of liabilities of the partnership to third parties.

The proposed change would permit a partner to deduct in the year of the loss his full share of partnership losses although in excess of the basis of his partnership interest if he is obligated to repay his share of such losses. As a matter of drafting convenience, the liability to repay his share of losses is referred to as a liability to the partnership. However, it is intended that the same result will obtain where the liability to repay is to the other partners or to some of them, rather than directly to the partnership. The interests of the revenue are amply protected against the subsequent forgiveness of a partner's obligations to the partnership by other provisions of the Code which tax the amount of such foregiveness as income.

The proposed change will not permit losses to be allowed to a partner in excess of the basis of his partnership interest where he is obligated to repay such losses on a conditional basis only (e.g., out of future profits) since, in these circumstances, the amount of the partner's loss, if any, has not been finally fixed.

Upon its passage by the House of Representatives, H. R. 8300 (subsequently enacted, with amendments as the Internal Revenue Code of 1954) contained a provision which would have accomplished the result here recommended. This provision was, however, stricken from the bill by the Senate Finance Committee without explanation.

The Secretary or his delegate should be permitted to exclude from treatment as partnerships certain unincorporated organizations, other than those organizations that elect to be treated as partnerships, without any requirement that all of the members must elect such treatment.

The present statute contains provisions for exclusion from the concept of partnership, for income tax purposes, of an unincorporated organization, but only if all of the members elect to be excluded. Experience indicates impracticability of an election by all of the members. The legislative recommendation eliminates the requirement that all of the members elect to be excluded. At the same time the recommendation preserves the privilege whereby such an organization (as distinguished from the members) may be taxed as a partnership. ☆

New decisions

Adjustment of partner's distributable share denied. Upon audit of a partnership return, the Commissioner disallowed a claimed rental-expense deduction and sought to increase the distributable income of taxpayer, a partner, by his share of the disallowed expense. Taxpayer's contention that this share had been included in his partner's return and that he was therefore entitled to some adjustment is held by the court to be without merit. *Lilly,* TCM 1956-207.

Collateral estoppel bars relitigation of family partnership. A partnership among taxpayers and several trusts established by them for the benefit of their respective wives and children was held invalid for tax purposes in a prior proceeding. The taxpayers are here held collaterally estopped from again litigating the partnership status of the trusts. Accordingly, taxpayers as individual partners are not entitled to have a portion of the net profits of the business attributed to the trusts; they are, however, permitted to deduct reasonable allowances paid or credited to the trusts for the use of trust capital in the business. *Stanback,* 27 TC No. 1.

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THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY BENJAMIN HARROW, J.D., CPA

"Sale against the box" tax avoidance plan is easy to foul up; error in press reports

ONE OF THE THINGS that keeps a tax man busy is explaining to laymen the somewhat cryptic summaries of alleged tax-savings deals published in newspapers, trade journals, or newsletters they see. Sometimes they confuse laymen and tax men alike. We recently saw an explanation by one newsletter of what it termed a "little known device" to protect paper profits in a securities or commodities deal and perhaps turn a tax-saving maneuver at the same time. It certainly was a job to straighten out the newsletter comment and explain in words of one syllable to our client—a not-so-dumb investor pretty alert to the ways of Wall Street.

How the example was set up

The report considered the case of an investor who believes in the long-term market for a certain stock he holds but is wary of the short term. Our first comment is that this is a queer way to put it — all such an investor has to do is to sit tight. A better way to characterize the hopothetical investor would be to say that he wants to hold onto his long-term shares, but that he would also like to profit from the dip he sees in the immediate future. He does not want to sell now and repurchase at the low he sees coming. He would have to pay a capital gains tax and thus reduce the funds he has working for him in the market.

Anyway, this is the investor the newsletter presents. He's bullish for the long term, bearish for the short term and anxious to protect paper profits. He owns stock bought at $50 which is now worth $100. He has had it more than six months, and now he sells short. (Note particularly that the short sales price must be $100; the confusion in the newsletter item arises because it forgets that market changes after the short sales date affect only the cost of stock bought to cover—not the proceeds of sale when the sale is covered.)

Suppose the market drops

Suppose the investor is right—the market drops to 90. He feels this is as low as it is going and decides to close out. He can use either the stock he owns or buy new stock (of course, that will be at 90) to cover. Ignoring for the time being whether gains and losses are long or short (we will come back to that and discuss the new Section 1233) this is his position:

TABLE I

	If he covers with	
	old stock	*new stock*
Cost of stock sold short	50	90
Proceeds of sale (short sale)	100	100
Gain	50	10

No matter how far the market drops, if he covers with his old stock he will always realize $50 gain—the short sale has protected his paper profit. If he sticks to his original plan and keeps the old stock for the long pull, he can cover by buying new stock. At 90, he makes a $10 profit, and the lower he can cover, the more profit he makes.

Suppose the market rises

Suppose the investor is wrong—the market rises after he sells short. His stock goes to 110. What is his position?

If the investor was wrong about the immediate drop, he can always cover with his old stock, realize the $50 gain he had when he acted at $100. He protected his paper profit at 100, but lost the benefit of the further rise of 110.

In this way, no matter what happens, he can realize his $50 paper profit, and if he's right, he can realize a gain on the dip without selling his old stock.

The tax effect

Now what is the tax nature of these gains and losses? Of course, all are capital— we are talking of an investor, not a dealer. The important fact to note is that at the date of the short sale he had his stock for over six months. Consequently, two of the rules of Section 1233 are not applicable. They come into play only if the taxpayer is simultaneously long and short *and* had held the property at the date of the short sale for less than six months. We can therefore ignore the rule making the gain on the short sale short term, even though the stock used to cover was actually held for more than six months at sale. This rule knocks out the device for converting short-term to long-term gain without market risk. We can also ignore the second rule starting the holding period of the stock not used to cover from the closing date.

But we are concerned with the third new rule. If substantially identical property was held for more than six months at the time the short sale was made, any capital loss resulting from a short sale must be treated as a long-term capital loss. The only time our investor will have a loss will be if the market rises and he buys new stock to cover (Table II; the $10 loss is long-term capital).

TABLE II

	If he covers with	
	old stock	*new stock*
Cost of stock sold short	50	110
Proceeds of sale (short sale)	100	100
Gain (loss)	50	(10)

Tax effect if market drops

Looking back at Table I, the $50 gain if he covers with the old stock will be long term. If he buys new stock to cover, the $10 gain will be short term. The lower the market goes before he covers, the greater the gain. But this gain is always short term.

It seems to us that the newsletter was wrong in the summary of this situation. It said that if the stock dropped to 90, the investor who covers with the shares

he owns has a long-term capital gain of 40. Aside from being $10 profit off per share, the newsletter does not point out that the investor will have fewer shares riding the market or that if he covered with new shares, and his gain is short term, he might take an awful beating if he is in a high tax bracket.

Tax effect if market rises

Looking at Table II, we see that Rule 3 of Section 1233 makes a long-term loss out of the loss incurred in buying new stock to cover. The newsletter overlooked this rule and also overstated the gain on old stock. The newsletter said that if the stock rose to 110, and the investor bought new stock to cover the short sale, a $10 deductible short-term loss resulted. It said that if old stock were used, the investor would have to pay a long-term gain on $60 per share. For these reasons, it continued, covering with new stock is advantageous, because the old stock could later be sold at full profit.

When to sell short against the box

It seems to us that there is only one logical situation in which an investor should use this device. That is when he does not want to cut down his market commitment and doesn't expect the market to go low enough so that he can buy the same number of shares with the proceeds of the sale, less tax. If in the example discussed, he expects the low to be less than 87½, he won't reduce the number of shares if he sells short. With his $100 proceeds, he can pay the capital gains tax of $12.50 and buy back at $87.50. He is in the same position marketwise, but he has a new higher basis.

If he does not expect a drop to 87½, then he might be wise to sell short against the box, cover somewhere in the nineties, take his short-term gain, and if he has no capital losses to offset, pay his ordinary income tax.

Cover with new stock

If he guesses wrong, and the market goes up, he had better cover with new stock (rather than reduce his total holding by selling old shares and rebuying a smaller number). This will give him a capital loss. If the chance of a useless capital loss seems great and the net-after-tax short gain (if the market does drop) small, then for this investor the sale against the box isn't an attractive speculation, and he would be wise to forgo it. ☆

Gas stations and the new Code: Real estate never seems to lose its tax glamour

TAX MEN tell us that clients are coming to them in increasing numbers currently with a "new" tax-minimization gimmick — a real estate deal (often today a huge gas station) which throws off good after-tax returns. What these clients don't realize, of course, is that these deals are nothing but the old classic real estate deal. What's new, though, is the big boost given such arrangements by the accelerated depreciation provisions of the new Code. With higher early depreciation deductions the early loss years are easier to manage.

In such a deal the financing is arranged so that the investor comes out with a deductible loss during the early years of ownership and a higher profit during later years. By using accelerated depreciation, this arrangement is even easier to set up. Of course, eventually the investor uses up his basis. But by then he is presumably not so concerned because he expects to retire, sell the property or make gifts to lower-bracket members of his family. Or his purpose might be entirely different. He might want this deal so that he can put the property into a personal holding company to neutralize securities income by making rental income 50 per cent of the gross.

How the figures work out

A typical case, with the figures worked out to show the tax and financial results of a 30-year leaseback in each of three ten-year periods, was set out in a recent bulletin published by one of the large accounting firms.

This deal would provide a spendable annual cash surplus representing a return of almost six per cent on the investor's cash investment. In addition, he receives an annual cash payment to amortize his original investment down to the expected value of the land (without buildings) at the end of the lease. Of course, this return and amortization are not paid as such — they are the difference between the annual rental and the payment on the mortgage.

These are the facts involved. Annual rent income is $23,760. For the 30-year lease, the total rent will equal the selling price of the property ($400,000) plus interest. The mortgage is $320,000, and annual flat payments required are $18,506. The investor's annual cash surplus is therefore $5,254. This $5,254 is an average return of 5.93% on his investment of $80,000 (selling price of $400,000 less the mortgage of $320,000) plus amortization of the $80,000 investment down to $40,000 (the expected value of the land at that time). The 30-year lease period is the estimated physical life of the building so that at the end of the lease period the value of the investment will be only the value of the land.

The annual gross income is the rental income, as used above in the cash statement, $23,760. But accelerated depreciation (declining balance, no salvage value, 30-year life) on the cost of the building ($360,000 of the total selling price of $400,000) will produce a deduction of $24,000 the first year. There is a loss without considering the interest on the mortgage! Of course, the annual deduction for accelerated depreciation drops down to about $13,000 by the tenth year.

Because the mortgage requires annual flat payments, the interest element in the payment is larger in the earlier years and it goes to swell the tax loss in the first ten of the 30-year lease period. It drops from $12,800 in the first year to about $10,400 in the tenth.

As a result of these two factors the investor has in the first ten years a tax loss totaling $58,374, as follows:

First year	$13,040
Second	11,212
Third	9,481
Fourth	7,841
Fifth	6,283
Sixth	4,802
Seventh	3,391
Eighth	2,044
Ninth	757
Tenth	(477) Profit
Total	$58,374

For the second ten years the total taxable income is about $58,000 and for the last ten about $117,400.

Well, as we said at the beginning,

there are lots of variants of this deal around. Don't be surprised when a client calls you up and begins: "Say, I've got a real estate proposition here that looks too good to be true, I'd like you to look at the tax angle . . .". ☆

New decisions affecting individuals

Taxpayer sold and mother bought through same investment counsel; loss disallowed. Investment counsel sold certain securities from taxpayer's portfolio to realize short-term losses. Within the period for wash sales, and in some instances on the same day, the investment counsel purchased approximately the same number of shares of these stocks for the mother. The court follows the *McWilliams* case (331 U.S. 694) in which a husband directed his broker to sell certain shares for him and to buy the same issues for his wife. The loss on the sales was disallowed as on a sale between related parties, though in fact the purchases and sales were made to strangers through the ordinary exchange procedure used by everyone. *Norton,* DC La., 9/28/56.

Installments of principal sum payable in six years not periodic alimony, Amounts received by taxpayer under a retirement bonus contract providing for the payment of $45,000 in 72 monthly installments of $625 are held taxable compensation and not gifts. Pursuant to a divorce decree, taxpayer paid his former wife one-half of these monthly sums. The court holds the payments were not deductible as "periodic alimony," because the monthly installments would end within six years and the Code specifically provides that such installments payable over less than ten years from the date of the decree are not alimony. *Leedom,* TCM 1956-224.

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Ballet angel lost $2 million; nondeductible because no profit motive. Anxious to develop the art of ballet in America, taxpayer, a principal dancer in the Ballet Theatre dance company, advanced large sums of cash starting in 1937 and continuing each year for 12 years to a total of almost 2 million dollars. Deductions had been allowed in some earlier years, but CA-2 had upheld the Tax Court in not allowing them for 1942. At issue here are 1944-1949. Despite the fact that taxpayer paid more attention to business problems in these years, the court finds that the reason it disallowed 1942 losses are still operating: the advances were not made to make a profit. ***Ewing,*** TCM 1956-205.

Subsistence allowances of state-highway patrolmen are additional compensation (old law). Taxpayer, a member of the Georgia State Patrol, was required to live in a barracks and was on call 24 hours a day. He received a subsistence allowance of $4.50 a day to defray the costs of his meals, which he ate at restaurants on his route. The court holds this taxable as additional compensation. The "convenience of employer" rule is inapplicable; it was argued that if the state supplied meals, the patrolmen would all be off-duty at the same time. The court concludes it cannot find that taxpayer's eating of meals in a restaurant of his choice, paid for from the subsistence allowance, should result in favored tax treatment denied all other employee-taxpayers who eat one or more meals away from home. [Under the 1954 Code, meals and lodging for the convenience of the employer are excluded, whether or not they are compensation. But this applies only to meals eaten on the business premises. *Ed.*] *Magness,* 26 TC No. 125.

Expectation of more deductions than income no excuse for failure to file estimate (old law). A taxicab operator with substantial income sought to excuse his failure to file declarations of estimated tax by contending that large damage suits pending against him might have reduced his taxable income to zero. The court holds that the contention is insufficient to constitute reasonable cause so as to absolve him from the penalty. *Maxey,* 26 TC No. 127.

Double penalty for not filing estimated tax incorrect. Taxpayer didn't file an estimated income tax return and paid two penalties—one for not filing a return and another for substantially underestimating his tax. The court holds that the penalty for underestimation was improper. [Under the 1954 Code, there is one penalty; the Commissioner has announced that he is not following cases with the above result.] *Glass,* DC Ga., 7/9/56.

Rental income may reduce retirement income credit. Where taxpayer performs services in connection with the repair and upkeep of rental property, 30% of the net rents constitutes earned income which is deductible from retirement income in computing the credit. [The Code defines earned income from a trade or business requiring both capital and personal services as a reasonable allowance not in excess of 30% of net. *Ed.*] *Rev. Rul.* 56-417.

Expenses of prescribed trip to Florida after stroke allowed. Taxpayer was hospitalized after he suffered a stroke. After two months in the hospital and a month of recuperation at home, he returned to work. A few weeks later, the physician who regularly attended him advised him to take a trip to Florida. The court allows his travel, food, hotel and reasonable incidental charges, but it disallows his wife's expenses. The court mentions as the closest case *Syringham* (183 F.2d 579), in which CA-6 upheld the Tax Court's allowance of medical costs, travel and meals and lodging of a child sent to an Arizona school for her health rather than a day school near home. [Under the 1954 Code, no deduction is allowable for meals and lodging. *Ed.*] *Embry,* DC Ky, 8/24/56.

Trip to improve morale not "medical." If a person suffering from a serious illness takes a trip, on the advice of a physician, to change his environment, or to improve his morale and thereby aid in the general mitigation of his condition, the expenses of the trip are not deductible as "medical care" expenses. *Rev. Rul.* 56-474.

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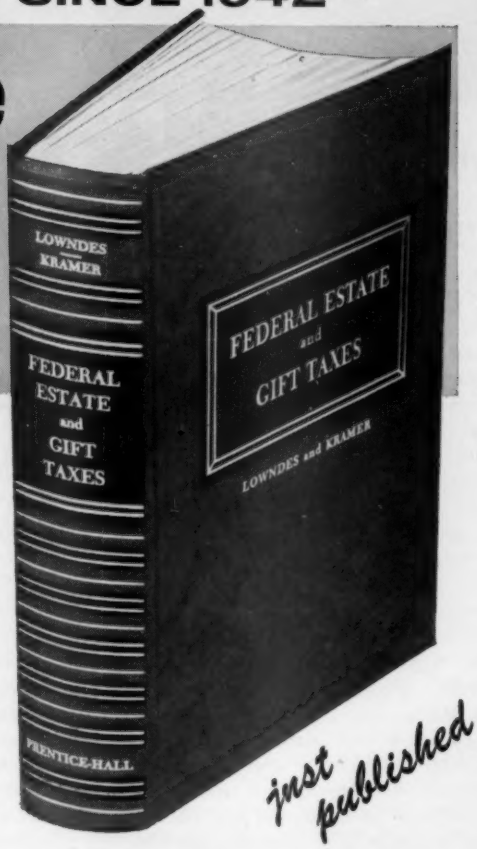

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NEW DEVELOPMENTS IN

Payroll taxes

EDITED BY PETER G. DIRR

Pennsylvania Supreme Court upholds unconstitutionality of double affirmation

On October 1, 1956 the Pennsylvania Supreme Court affirmed the decision of May 16, 1956 of the Court of Common Pleas of Dauphin County, Pennsylvania which held that the "Double Affirmation Clause" of Section 501(e) of the Pennsylvania Unemployment Compensation Law violated the due process clause of the United States Constitution. The suit was brought by a number of Pennsylvania employers who sought to prevent unemployment insurance payments to employees of the Westinghouse Electric Corporation until the eligibility of the claimants was finally determined by the Superior Court.

During a strike in which the Westinghouse employees were engaged, a proposal that the dispute in question be referred to arbitration was made by the Governor. The Westinghouse Electric Corporation rejected this proposal and the Department of Employment ruled that ". . . what had theretofore been a strike became a lockout because of the Company's rejection of the terms specified by the Governor . . .". Westinghouse appealed this ruling.

Section 501(e) contains the "Double Affirmation Clause" whereby the payment of unemployment benefits is permitted in the event of two administrative findings for the claimant even if an appeal is taken to the Courts. Since approximately $9½ million dollars in benefits was involved, the Company contended that if such benefits were paid there would be a serious depletion of the Fund and an adverse effect on unemployment insurance rates. In view of these consequences the Company sought to prevent the payment of these benefits until the question of the "lockout" was ruled on.

The Courts not only held that no benefit payment should be made until there is a review of the eligibility question, but further held that the "Double Affirmation Clause" of the Pennsylvania Law was inconsistent with the due process of the Law. ☆

Provisions of new Social Security tax

1956 being an election year, it was almost a foregone conclusion that the Social Security Program would be liberalized. The major provisions of the new amendments are:

1. Benefits are made available to women at age 62 in various degrees:

a. Widows can get the full amount which is presently payable at age 65.

b. Working women can retire and collect 80% of the full amount presently payable at age 65.

c. Wives of retired workers can collect 75% of the full amount presently payable at age 65.

c. Wives of retired workers can collect 75% of the full amount presently payable at age 65.

This change is applicable to benefits of November, 1956.

2. Additional groups of self-employed have been brought under coverage. Physicians are the only major category presently left uncovered.

3. Totally-disabled workers can collect benefits equal to normal retirement benefits starting at age 50. First payments are effective July 1, 1957.

4. Beginning January 1, 1957, benefits are payable to children, regardless of age, who are permanently and totally disabled prior to their 18th birthday, if their disability has continued beyond age 18. In the case of a disabled child, the mother of the child will also be eligible for benefits so long as she continues to have the child in her care.

5. To finance the disability provisions, an additional tax of ¼ of 1% is levied against both the employer and employee on the first $4,200 of wages. The tax on self-employed is ⅜ of 1% on the first $4,200 of income. This tax will be kept in a separate trust fund but will be collected as part of the regular Social Security tax. The increased tax rates are effective January 1, 1957.

This political approach to social security liberalizations is presently being made the subject of searching examination by many organizations. It is feared that too much may be expected of the Government's social security program and that in order to pay for continuous liberatizations the cost could become so high as to "discredit" the entire program.

Msgr. John O'Grady, Secretary of the National Conference of Catholic Charities, in testifyying before the Senate Finance Committee early this year warned that the current amendments would increase the cost of the program to 9% of payroll by 1975 and if Congress keeps lowering the age limits a 15% payroll tax may eventually be necessary. ☆

New changes in Mass. unemployment law

Beginning with the calendar year 1957, employers will be eligible for reduced rates after benefits have been charged to their account throughout the 12 consecutive months ending on the prior September 30th computation date.

Effective with claims filed on and after October 1, 1956, benefits will range from a minimum of $10 weekly to a maximum of $35 weekly. The range formerly was $7 to $25 weekly.

An individual may now receive total benefits during a benefit year equal to 34% (formerly 30%) of his base period wages or 26 times his weekly benefit rate, whichever is lesser, and if the individual is certified as attending an industrial retraining course provided by the Department of Education in a vocational school of the Commonwealth or subdivision, his total benefits may be extended by ten times his benefit rate. The additional benefits are only payable while he is attending such course and is otherwise capable of and available for work. These additional benefits, if not chargeable to any particular employer, are charged to the solvency account. ☆

Available November 15

NEW COMBINED PAYROLL WITHHOLDING TABLES

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These tables were prepared by the tax department of McKesson & Robbins, Inc., under the direction of Peter Dirr, who is also editor of the Payroll Taxation department of THE JOURNAL OF TAXATION. The format has been tested in actual use during the past two years—the only change now is in the insertion of the new figures to give effect to the new law.

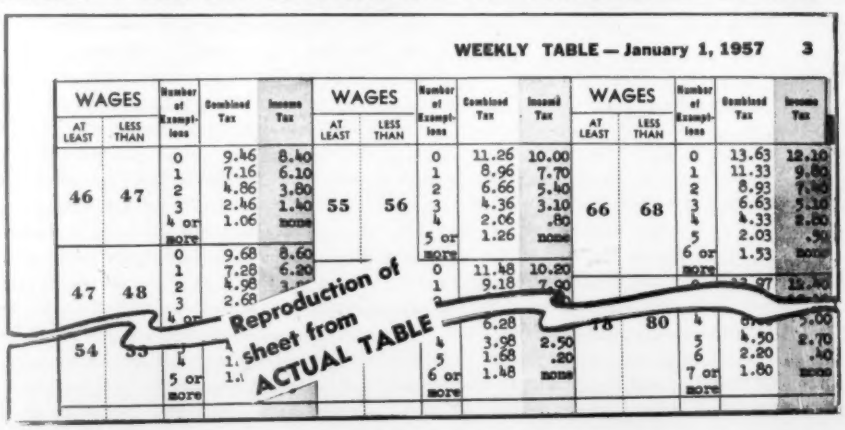
Each set of tables contains withholding for all pay brackets, showing both income-tax and social security withholding separately and combined—for daily, weekly, bi-weekly, semi-monthly, monthly, and miscellaneous pay periods. An easy thumb index makes any table easy to find. Tables are printed on heavy ledger paper, spiral bound (it lies flat), in heavy cardboard cover, 22 pages, 8½ x 11 inches.

Because these tables are an absolute essential at every payroll installation, a special discount is being made now so that every payroll office can have one. Price, per set: $2.95. For 12 to 25 sets: 10% discount; 26 to 100 sets; over 100 sets: 15% discount.

Your copies may be ordered now. The tables will be off the press November 15 and mailed at once in time for use after the first of January.

A sample of the tables appears below. Use order blank below to order.

NOT TO BE CONFUSED WITH GIVE-AWAY SHEETS SHOWING OLD DATA OR LIMITED INCOME-TAX OR F.I.C.A. WITHHOLDING ONLY. THESE NEW TABLES ARE EFFECTIVE JANUARY 1, 1957, AND COVER COMPLETE WITHHOLDING FOR ALL SITUATIONS



WEEKLY TABLE — January 1, 1957 3

WAGES		Number of Exemptions	Combined Tax	Income Tax	WAGES		Number of Exemptions	Combined Tax	Income Tax	WAGES		Number of Exemptions	Combined Tax	Income Tax
AT LEAST	LESS THAN				AT LEAST	LESS THAN				AT LEAST	LESS THAN			
46	47	0	9.46	8.40	55	56	0	11.26	10.00	66	68	0	13.63	12.10
		1	7.16	6.10			1	8.96	7.70			1	11.33	9.80
		2	4.86	3.80			2	6.66	5.40			2	8.93	7.40
		3	2.46	1.40			3	4.36	3.10			3	6.63	5.10
		4 or more	1.06	none			4	2.06	.80			4	4.33	2.80
							5 or more	1.26	none			5	2.03	.50
												6 or more	1.53	none
47	48	0	9.68	8.60			0	11.48	10.20					
		1	7.28	6.20			1	9.18	7.90					
		2	4.98	3.80			2							
		3	2.68	1.40			3							
		4 or												
54	55	4	1.	1.			4	6.28		78	80	4		5.00
		5 or more	1.	1.			4	3.98	2.50			5	4.50	2.70
							5	1.68	.20			6	2.20	.40
							6 or more	1.48	none			7 or more	1.80	none

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NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

Facts which will provide capital gain on sale of equipment held for lease

THE THIRD CIRCUIT has just given us a good answer to the troublesome question, so often litigated, of when is gain on sale of assets formerly leased capital or ordinary. In the *Philber* case, (*Philber Equipment Corp.*, CA-3, reversing 25 TC 88) the court points out the several facts that cause it to conclude that the assets were not "held primarily for sale." [See page 376. *Ed.*]

So long as we have the rule of Section 117(j) of the old Code (Section 1231 of the 1954 Code), we are going to have with us difficult problems in distinguishing between "property held primarily for sale" (the gain is ordinary), and property used in the business (the gain is capital). We think the court comes up with a well-reasoned analysis of the distinction between the two. We have drawn from the opinion those passages which are germane to this question. This is how the court put it:

Taxpayer was engaged in the business of furnishing trucks, tractors and trailers to the public on a lease basis, principally to fleet operators who would rent from three to fifty-five units. The leases, during the fiscal years 1951 and 1952, [the years before the court. *Ed.*] were all for a one-year term although a number of units were retained by the lessees for a few months longer than one year, pending their replacement with new vehicles under a new lease . . . During its fiscal years 1951 and 1952 the average number of units owned by taxpayer was one hundred seventy-five. Its gross rental income was $295,889.39 for the fiscal year 1951, and $267,754.53 for the fiscal year 1952. Except for $4,000 all of the rental income for the years involved was received from nine customers.

During the taxable years, existing conditions made it difficult or impossible to re-lease most of the equipment. Taxpayer knew that when equipment was purchased it would probably be able to rent the equipment for a period substantially less than its useful life, and sale of the equipment would follow expiration of a lease.

Taxpayer did not have a sales force, a showroom or other selling facilities, and it held no franchise from any manufacturer, nor was it licensed under the Pennsylvania Motor Vehicle Sales Finance Act. The vehicles previously rented were sold by taxpayer through its agent, Berman Sales Company ("Berman"). Berman, a large-scale dealer in trucks, tractors and trailers, is a partnership, the interests of which are held by the same persons who hold the capital stock of taxpayer and in the same proportions as their stock holdings. There was an informal but consistently followed arrangement whereby Berman sold the trucks, tractors and trailers of taxpayer in the normal course of its business.

Taxpayer sold forty of its vehicles through Berman during the fiscal year 1951. The net gain to taxpayer was $16,323.53. For the fiscal year 1952, forty-five vehicles were sold resulting in a net gain to taxpayer of $33,247.31. Each unit sold had been held by taxpayer for a period in excess of six months and was subject to an allowance for depreciation.

Tax Court holding

. . . The Tax Court made the factual finding that the vehicles sold constituted ". . . property held primarily for sale to customers in the ordinary course of petitioner's trade or business, and the gain from the sales thereof is taxable as ordinary income."

With respect to that finding it must be noted it was in the nature of an ultimate finding of fact and since such finding is but a legal inference from other facts it is subject to review free of the restraining impact of the so-called "clearly erroneous" rule applicable to ordinary findings of fact by the trial court. . . .

Purpose was rental

With respect to the question as to whether or not taxpayer held the property primarily for sale to customers in the ordinary course of its trade or business, the Commissioner contends that "primarily" means "substantial" or "essential" rather than "principal" or "chief". In *Rollingwood Corp. v. Commissioner*, 190 Fed. (2d) 263, 266-267 (9th Cir. 1951), the Commissioner's definition was adopted. *Rollingwood* was one of the numerous war-time housing operation cases where individuals normally in the business of selling houses were required to turn to rental activities due to war-time restrictions. Anticipation of selling activities with respect to the rental housing is an important consideration in many of these cases, so that the dual purpose of rental and sale is quite an inseparable factor in determining for what purpose the property is "primarily" held. Whether "primarily" means "substantial" or "principal" is not dispositive of the question, and attempts to seek an alternative definition of the statutory word are an illusive guide to the solution of a problem which must rest upon the variation of facts presented. Semantic excursions are often necessary to formulate a working guide under inexplicit statutory phrasing; however, words are seldom meaningful unless the application to the facts is for the purpose of more clearly posing the question, not answering it.

The basic problem is whether, as the Commissioner contends, the property was acquired for the dual purpose of leasing for a period substantially less than its useful life, and thereafter selling; or, as the taxpayer urges, its purchase, use and ultimate disposition were directed to the single purpose of the operation of a truck rental business. We are here concerned with a going operation which involves continuous rental, purchase and sale, and the determinative factor is the purpose for which the property was held at the time of its acquisition and during the period of its use. . . . The final sale of the property can only be decisive if the taxpayer's business was operated with the final

gains from the sale of the vehicles as a determining business purpose. We think the record supports the taxpayer's contention that the acquisition, use and disposition of its equipment was consistent with the business purpose of vehicle rental and not vehicle sale.

With respect to the acquisition of the property, it is critically significant that the taxpayer never purchased a vehicle until a leasing arrangement had been made and that the type of vehicle so purchased was dictated by the particular requirements of the lessee. . . . Taxpayer carried no inventory or stock of equipment.

Concerning the use of the equipment, all property owned by the taxpayer was used as rental equipment. No right was given the lessee to purchase or acquire any interest in the leased equipment. Upon expiration of the lease, the equipment was returned to taxpayer to be replaced, where another lease was agreed upon, with new equipment.

The frequency, continuity and substantiality of sales are important factors to consider in determining for what purpose property is primarily held. However, these are factors among many others to be taken into consideration. The nature of taxpayer's business required the substantial sales made, but such sales were not part of a business of selling trucks but rather the natural conclusion of a vehicle rental business cycle. Further, the rental period was not the result of a voluntary act on taxpayer's part, but rather an unavoidable consequence of conditions existing in the business. The acquisition and disposition of equipment was an essential aspect of the business of renting equipment and the officers of taxpayer were aware that property acquired must ultimately be disposed of. Standing alone, such disposition, even though a necessary and frequent element of taxpayer's business, cannot be considered inconsistent with the conduct of a rental business or make the sale factor a dominating business purpose of taxpayer.

Sales agent affiliation irrelevant

The fact that it elected to sell its equipment through the agency of Berman is not a decisive factor in determining its business purpose. The circumstance that it did not through its own facilities conduct the selling operation is another factor supporting the conclusion that its primary business purpose was vehicle rental. To hold, as the Tax Court did, that employment of Berman's sales facilities amounts to taxpayer itself engaging in the act of selling ignores the realities of the situation. True, the interests in taxpayer and Berman were identical, but both were legitimate business enterprises, and there is no suggestion in the evidence of any lack of business purpose in the activities or relationship of the two entities. Taxpayer's rental business was a practical concomitant to its ownership interest in the Berman selling enterprise, and reliance on the advantages of disposing of equipment through Berman was a logical business arrangement.

Change of purpose

The Tax Court, as an alternative ground, stated that even if the intention to sell had been absent at the time of the original acquisition, such intention did exist at the time of repossession from the lessee, and the determining factor is then the purpose for which the property was being held at the time of sale rather than the purpose for which it was originally acquired and held.

We cannot subscribe to this "alternative ground". To do so would make for judicial nullification of Section 117(j).

The essence of the Tax Court's alternative ground is that property changes character merely by the fact of its being exposed for sale. We agree with the taxpayer that such a concept is neither logical nor reasonable. ☆

Senate hearings link gas-industry group fees to lobbying; may not be deductible

THE SENATE COMMITTEE investigating large-scale lobbying on the natural gas bill recently pointed out that gas companies may have violated IRS rules by deducting as business expenses their contributions made to their lobbying group, the Natural Gas & Oil Resources Committee (NGO). The issue was raised when Leonard F. Mc Collum, president of Continental Oil Company, told the Senators that the group's money was spent not on efforts to push the bill through the Senate but on a long-range educational program to promote better understanding of the industry.

When Mr. Mc Collum intimated that most companies probably deducted the contributions as business expenses, the committee's General Counsel, George Morris Fay, pointed out that expenditures for lobbying purposes are not deductible. The committee, headed by Senator McClellan, then developed the question of what is lobbying. We've edited the transcript of the hearings, both before and after Mr. Fay's statement, to bring out the tax issue:

Mr. Fay: Mr. McCollum, did the Natural Gas & Oil Resources Committee secure a ruling from the Internal Revenue Service as to its tax status?

Mr. Mc Collum: I don't think we did; I don't think we even attempted.

Mr. Carson [Mc Collum's counsel]: I know that they did not seek such a ruling.

Mr. Fay: Mr. Mc Collum, Continental Oil contributed a substantial sum of money to NGO?

Mr. Mc Collum: Yes sir. I don't know what you mean by substantial.

Mr. Fay: In excess of $10,000.

Mr. McCollum: Yes sir.

Mr. Fay: Do you know how Continental Oil handled that contribution on its books? Was there a contribution to an educational committee, or was it merely a business expense?

Mr. Mc Collum: I haven't looked at the books, but I would bet a dollar to a doughnut it was a business expense.

Mr. Fay: Have you any knowledge as to how the other contributors to NGO handled their contributions?

Mr. Mc Collum: No sir, other than this: At one time during or after the formation of this committee, the question was raised about getting a tax exemption. So far as I remember, I and the other members of the committee took no interest in it.

Mr. Fay: Are you drawing a conclusion from that, that they undoubtedly handled the contribution the same way?

Mr. Mc Collum: I am assuming they charged it to business expense.

Other efforts

A little later Mr. Fay questioned Mr. Mc Collum about the individual companies' efforts to educate the public.

Mr. Mc Collum: I think that the record will reflect that our little company spends perhaps half a million dol-

IRS, SENATE INVESTIGATE

THE QUESTION of whether payments to Natural Gas & Oil Resources Committee are deductible as ordinary business expense is being investigated by IRS and by the Senate Committee to Investigate Corrupt Practices, it has been announced recently. IRS field agents are examining NGO activities to try to determine whether its activities are "lobbying," hence nondeductible, or not.

lars a year trying to inform the public on natural gas and oil business. This is in addition to our product advertising budget.

Senator McClellan: In other words, your company carries on a continuous program?

Mr. Mc Collum: Yes, we carry on a continuous program.

Senator McClellan: How many years have you had that?

Mr. Mc Collum: I have been in the company seven or eight years, but it has been the larger part of that. We hope to continue and expand it. Some of that is institutional advertising and selling, but a great deal of it is industry selling, that is, not product advertising, which is separate and apart.

Senator McClellan: How do you charge it on your company's expenses?

Mr. Mc Collum: Administrative expenses.

Senator McClellan: It is not charged as advertising?

Mr. Mc Collum: No, advertising budget is separate and apart from public relations.

Senator McClellan: You charge all public relations expense to the cost of administrative expense?

Mr. Mc Collum: The bulk of it would go there.

Senator Thye: Has the Internal Revenue Service ever questioned that manner of carrying that expense on your books?

Mr. Mc Collum: If so, it has not come to my attention.

Mr. Fay: You are aware that Internal Revenue Section 23(a)(1), which relates to expenditures for advertising incidental to or expended for lobbying purposes, the promotion or defeat of legislation and the exploitation of propaganda other than trade advertising, says that such expenses are not deductible from the gross income of a corporation?

Mr. Mc Collum: I dare say our General Counsel and Comptroller know, but I don't know.

Senator Anderson: Did you deduct the cost of those booklets you sent to the station managers and everybody else?

Mr. Mc Collum: I don't know. I would have to check.

Senator Anderson: As a matter of fact, you did deduct them as expenses if you charged them to administrative expenses, didn't you?

Mr. Mc Collum: If they were charged to administrative expense, they would be a business expense.

Senator Anderson: Would you regard that as compliance with that lobbying statute when you were trying to defeat legislation or promote legislation?

Mr. Mc Collum: Now, wait a minute—the bulk of our public relations expenditures are not directed to obtaining legislation.

Senator Anderson: Your oil company spent $57,000 in the NGO. Did you segregate that from your ordinary expenses under this lobbying provision? Certainly it was intended to influence legislation.

Mr. Mc Collum: Let me make the record straight: There was no lobbying on the part of the committee at any time; we contributed the funds with the distinct understanding there would be no lobbying. The funds were charged to general business expense.

Mr. Fay: Was it charged to any particular item?

Senator McClellan: When you say that these funds were not contributed for lobbying purposes, do you mean lobbying as applied to contacting members of Congress and trying to influence their votes?

Mr. Mc Collum: Senator, I mean that it would in no wise violate existing lobbying laws.

Senator McClellan: In other words, it would not be used in any way that would make your committee subject to registration under the lobbying law, is that what you mean?

Mr. Mc Collum: That is right.

Senator McClellan: But if a form of lobbying is building up public sentiment so as to influence legislation, then you could not say that the contribution was not made wholly or exclusively for purposes other than lobbying.

Mr. Mc Collum: The effort of this organization was not solely or principally even to obtain legislation immediately. It was to develop a background, as a result of which there could be legislation. Therefore, we considered we were not contributing money directly or indirectly to obtaining legislation, although we hoped or expected some results would be favorable legislation.

Senator McClellan: Could not other people place different interpretations on the action in that the ultimate results or hope, or a part of it, was to influence legislation—that this would be a contribution to what we might term at the moment indirect lobbying?

Mr. Mc Collum: If you leave out "indirect lobbying," I might agree with the statement more.

Senator McClellan: I cannot quite leave it out.

Mr. Mc Collum: Then I will have to say "No."

Senator McClellan: You understand that this committee, as well as trying to inquire into what may have transpired in connection with this particular bill, is also undertaking to develop what to date prevails as a general pattern in this field so that we might possibly recommend legislation to remedy conditions if we find they are not wholesome, even though not covered by present law. Therefore, the question arises whether a contribution to an educational program that has for part of its design and purpose the influencing of legislation is a form of lobbying in the broadest adaptation of the term.

Mr. Mc Collum: I am no expert on the Lobbying Act. Neither am I prepared to enunciate what might be the solution to your problem. It is crystal clear to me that the purpose and effort of this enterprise or this campaign or this educational program was far broader and is far broader and will continue to be far broader than one piece of legislation.

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If that should be regulated, I am not prepared to say.

Senator McClellan: I am not prepared to say that it should be, but I think it is the duty of this committee to develop all facts and present-day practices in this field so that we might evaluate it and possibly arrive at some conclusion as to whether it is good, it ought to be continued, whether there ought to be some legislative regulation of it, or whether any part of it should be prohibited.

I do not know what could or should be prohibited at the moment. But what I am trying to point out here is that this procedure which your committee followed may be construed as one form of lobbying. Obviously, your industry is not the only one that conducts an educational program of this character, and some of these are obviously conducted primarily to build sentiment to influence legislation. If that is its purpose, is not that a form of lobbying in the broadest interpretation of the word? ☆

Profit from tax deferment (via depreciation) is greater than is generally realized

MOST MANAGEMENTS are aware that extra cash obtained by the deferment of tax liabilities through earlier depreciation can be reinvested in the business at a profit pending its absorption later on by the payment of the deferred liabilities. In developing this idea, George Terborgh, research director of Machinery and Allied Products Institute, points out that "it is even possible, if a rate of profit is specified, to figure out what cumulative gain from this reinvestment will remain after the deferred payments have been made. It is not always realized, however, that the advantage of faster deductions does not depend on the reinvestment of the added cash received in the early years, but exists even though this cash is withdrawn from investment entirely. In this case the gain appears in the form of a higher rate of after-tax return on the investment in the depreciable asset itself."

MAPI is currently preparing a study on the effect of depreciation policy (especially the accelerated depreciation permitted by the 1954 Code) on the earnings of depreciable assets. Pending the publication of the complete study, Mr. Terborgh has written a monograph *Effect of the New Tax Depreciation Methods on the Earnings of Depreciable Assets. This interesting study has recently been published by the Institute.*

Mr. Terborgh demonstrates here how a higher rate of after-tax return is obtained on an investment in depreciable assets when the sum-of-the-years-digits method is used.

The general principle involved in this improvement of the rate of return can be illustrated by a very simple example, he says. If an investor commits $1,000 today and gets back $1,100 a year from now, his rate of return is ten per cent per annum. If, however, he gets back the $1,100 at the end of six months, his rate of return is 20 per cent. With the same recovery in three months, the rate is 40 per cent. Similarly, an earlier receipt of the amounts available for capital recovery and after-tax return over the life of a depreciable asset, arising from the use of a faster tax depreciation method, spells a higher rate of return.

We have, let us say, a depreciable asset costing $10,000 (all of which is assumed to be equity money), with a service life of ten years and no terminal salvage. The income tax rate is 50 per cent. The operating-margin (excess of revenue produced by the asset over cash operating costs) contribution starts at $3,594 the first year and declines to $359 the final year. In the table below we trace the effect, on the portion of the margin remaining for capital recovery and after-tax return, of substituting sum-of-digits for straight-line tax depreciation.

What do these differences do to the

Computation of Amounts Available for Capital Recovery and After-Tax Return, with Straight-Line and With Sum-of-Digits Tax Depreciation, for the Hypothetical Asset Described[a]

Year of Service	Assumed Operating Margin Contribution	Tax Depreciation		Taxable Income		Income Tax		Operating Margin after Tax	
		Straight-line	Sum-of-digits	With Straight-line (1–2)	With Sum-of-digits (1–3)	With Straight-line (50 per-cent of 4)	With Sum-of-digits (50 per-cent of 5)	With Straight-line (1–6)	With Sum-of-digits (1–7)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
1	$3,594	$1,000	$1,818	$2,594	$1,776	$1,297	$888	$2,297	$2,706
2	3,234	1,000	1,636	2,234	1,598	1,117	799	2,117	2,435
3	2,875	1,000	1,455	1,875	1,420	938	710	1,938	2,165
4	2,516	1,000	1,273	1,516	1,243	758	621	1,758	1,894
5	2,156	1,000	1,091	1,156	1,065	578	533	1,578	1,624
6	1,797	1,000	909	797	888	398	444	1,398	1,353
7	1,438	1,000	727	438	710	219	355	1,219	1,082
8	1,078	1,000	545	78	533	39	266	1,039	812
9	719	1,000	364	−281	354	−141	177	859[b]	542
10	359	1,000	182	−641	178	−320	89	680[b]	271
Total	$19,766	$10,000	$10,000	$9,766	$9,766	$4,883	$4,883	$14,883	$14,883

[b]Assumes that the excess straight-line deductions of Column 4 can be offset against income from other sources.
[a]Figures may not check exactly because of rounding.

after-tax rate of return on the investment in the asset? To answer this question we must find the rates of discount at which the figures of Columns 8 and 9 have a present worth, at the beginning of the service life, of the amount originally invested—$10,000. The rate for Column 8 is 10.00 percent and for Column 9 is 11.37 percent. In this case, therefore, the substitution of sum-of-digits tax depreciation for straight-line increases the after-tax return by 1.37 percentage points, or by 13.7 percent of the straight-line return rate. ☆

New accounting decisions this month

Sums received on stock sale not taxable as compensation. The $60,000 received by taxpayers upon sale of their 50% stock interest to the remaining shareholder is held to be consideration for the sale of the stock. No part of this sum was compensation for taxpayer's termination of his employment with the corporation. *Marcelle,* TCM 1956-223.

"When and if issued" sale effective on date of issuance. Taxpayer sold the right and option to acquire oil and gas leases "when and if issued," payment being contingent upon the issuance of the leases under pending applications with the Department of the Interior. The court holds the agreement became effective as a contract of sale when each lease was issued; the resulting gain was therefore a short-term capital gain. *Lack,* TCM 1956-222.

CAPITAL GAIN

Capital gain on sale of trucks purchased for rental. Taxpayer-corporation was in the business of renting trucks. It bought trucks only when it had a lessee for them. It carried no stock. It sold used trucks on the expiration of the lease agreement when re-rental was usually not feasible. These sales were made through a dealer-partnership composed of its stockholders, each of whom had the same proportionate interest in each entity. The Tax Court held that the trucks were held primarily for sale. This court holds that the trucks were acquired, used and sold as part of a rental business, and that the sales were the normal ends of renting cycles. The trucks were held primarily for use in the rental business. Gains on their sales are capital. [See comment, page 372. *Ed.*] *Philber Equipment Corp.,* CA-3, 9/27/56.

Attorneys had ordinary income from sale of lots. Taxpayers, practicing attorneys, purchased unimproved property in 1944. In 1946, they improved the property and subdivided it into 46 lots. That same year they listed the lots for sale and sold four of them. The following year they sold two more, and in 1948, they sold ten more. Taxpayers claimed capital gains treatment for the 1948 sales. The court holds that the property was held by taxpayers in 1948 primarily for sale to customers in the ordinary course of a trade or business. *Skopil,* DC Oreg., 9/24/56.

Improved rental properties are not capital assets. Taxpayer-trust realized losses on the sale of improved rental properties. The losses are held to be ordinary losses on "property used in a trade or business" and are not available as a capital loss carryforward. *Stern Trust,* 26 TC No. 152.

Post office lease-purchase agreement a sale of real property. A lease-purchase agreement under the Post Office Department Act of 1954 constitutes a sale of a building to the U. S. by the successful lease-purchase bidder. The profit from the sale may be reported under the installment method. That portion of each installment which represents interest on the unpaid purchase price is to be separately treated and is includible in gross income. *Rev. Rul.* 56-498.

Sale of timber results in ordinary income. Having at no time engaged in logging activities, a lumber company sold timber to others who agreed to do the logging. Since the timber sales were the only activities carried on by the company, the court holds the timber was "property held for sale to customers in the ordinary course of business." Accordingly, gains derived from the sales could not qualify as capital gains under Section 117(j); they were ordinary income. [Section 117(j) applies only to property used in the business. The provisions of Section 117(k) allow capital gain on cutting of timber only if the owner maintains an economic interest in the timber. *Ed.*] *Ah Pah Redwood Co.,* 26 TC No. 149.

Seller of houses was primarily landlord; gain is capital. Taxpayer owned 22 houses which he rented. In 1945 and 1946, he sold some of the houses. The Commissioner contended that taxpayer was a dealer and that gains from other sales in 1947 and 1948 were not capital. The court finds the houses were held primarily for rent, and not for sale; taxpayer, it holds, was trying to accumulate rental property for income. Since gains from sales of property used in a trade or business are capital gains, taxpayer did not have ordinary income on the sales. *King,* DC Tex., 9/7/56.

Ordinary income on sale of lots. Income from the sale of lots is held to be ordinary income rather than capital gain. The property was subdivided and actively advertised, and the sales were frequent and had a definite continuity. That the activities were carried on by others for taxpayer's benefit did not affect the business character of the operations. *McDonough,* TCM 1956-215.

Recovery on claim received in corporate liquidation is capital gain. Upon dissolution of a trading corporation, taxpayer as stockholder received in liquidation a claim for a shipment of merchandise to China lost in 1941. The court finds the claim had no value then. A recovery on the claim by taxpayer five years later is held to constitute long-term capital gain and not ordinary income. *Burnett,* TCM 1956-210.

Lawyers trading in vacant lots were dealers. A lawyer and real estate broker, the taxpayer purchased in conjunction with two other lawyers over a four-year period 200 vacant encumbered city lots. Generally, they sold the lots to construction companies or contractors, after the liens were cleared. They did not advertise. The court holds the purchases and sales were not infrequent and sporadic, but were continuous and substantial. Taxpayer was therefore a dealer in vacant lots; the gain derived from the sale was taxable as ordinary income, and was also subject to the self-employment tax. *Philbin,* 26 TC No. 145.

Ordinary loss on sale of rental property. In May 1944, a beneficiary of a trust re-

ceived an undivided one-fifth interest in certain real property. From that time until she sold the property at a loss in February 1945, she and the other co-owners rented the property for income purposes. The loss on sale was an ordinary loss from realty used in a trade or business. *Post,* 26 TC No. 135.

DEDUCTIBILITY

Can deduct payment to OPA; had reasonably expected approval of over-ceiling price. Taxpayer had charged more than its ceiling price during September 1942 to January 1943, but in billing customers, it had stated the situation and offered a refund if the ceilings were not changed retroactively. The OPA did subsequently amend the price, but not retroactively. The OPA ordered the taxpayer to pay the overcharge (without penalties) to the Government. The court affirms the trial court's allowance of this payment as a deduction. The taxpayer had good reason to expect the change would be retroactive, and to allow the deduction would not be contrary to public policy. *Star Kist Foods, Inc.,* CA-9, 9/21/56.

Demolition loss allowed; decision to raze made after purchase. In order to acquire a suitable site for an auto-sales agency, taxpayer was forced to buy an adjoining lot and residence as part of the deal. At the time of purchase, he planned to remodel the residence for commercial-rental purposes, but because costs were too high, the plan was abandoned. Later, when he found he was unable to rent the building, he had it demolished. The Tax Court holds the cost of demolition was deductible. Although no loss is allowable on property purchased with the intention of razing it, this taxpayer at the time of purchase intended to use the building. *Maples,* TCM 1956-217.

Beer dealers can't deduct expense of campaign to defeat legislation by referendum. Taxpayer, a wholesale beer distributor contributed to a fund which beer and wine dealers established to defeat, by publicity, proposed legislation which would place retail beer and wine sales in state-owned and -operated stores. The proposal was in the form of an initiative or referendum measure. The court holds that the Regulations have long provided that funds spent to influence legislation are nondeductible. Whether the funds are spent to influence members of a legislature or the general public with respect to an initiative measure is immaterial. *Cammarano,* DC Wash., 3/19/56.

Automobile taxes must be capitalized. Taxpayer purchased a new Cadillac for his business. The court holds the amount paid representing Federal excise and state sales taxes should have been capitalized and was properly disallowed as a deduction. *Berry,* TCM 1956-208.

Remodeling costs must be capitalized. Taxpayers leased a former bowling alley which was in very bad shape. They proceeded to remodel it to make it suitable for the operation of bingo games. Of the $22,500 they expended for the installation of washrooms, heating and air conditioning equipment, a completely new floor and other items, only the cost of temporary facilities constructed to permit the continuance of business during reconstruction is allowed as a repair expense. *McDonough,* TCM 1956-215.

DEPLETION

No revision of depletion allowance; error was ascertainable. Taxpayer is denied in 1954 a revision of its depletion allowance for 1948 and 1949 on the basis of corrected estimates of recoverable units. The error in the prior estimate was readily ascertainable during 1948 and 1949, but it was not in fact determined until later. Consequently, the computations for the taxable years should stand as in accord with the facts as actually known then. *Ah Pah Redwood Co.,* 26 TC No. 149.

ACCOUNTING METHODS

Accrual-basis taxpayer has loss in year title passed, not year contract to sell was signed. The contract to sell was entered into in 1947, but title was not transferred until 1949 because of difficulties in perfecting title. In the event of damage to the property, the purchaser could have refused conveyance. In holding that the loss was not sustained in 1947, the court stresses the retention of possession and the risk of loss. *Rich Lumber Co.,* CA-1, 10/11/56.

Court permits Commissioner to disallow accruals despite taxpayer's inventory. Although the taxpayer used inventories, the court holds that the Commissioner may disallow accrued expenses. The court remarks briefly that the Commissioner has wide discretion where the books do not clearly reflect income. *Wasson,* DC Tex., 9/12/56.

Installment election requires timely and affirmative action. In their 1950 returns, taxpayers reported the full net gain on the sale of realty. They are held precluded from thereafter electing to use the installment method. *Vischia,* 26 TC No. 132.

WHAT IS INCOME?

Naval retirement pay for other than physical disability taxable. Taxpayer voluntarily retired from the Navy in 1931 for reasons of age and length of service. He was recalled to active duty in 1941 and later released when found unfit. Upon release he continued to receive pay allowances based upon his original retirement status. Since the allowances were not based upon "sickness or personal injuries resulting from active service," no grounds existed for exclusion of the payments. *McNair,* 26 TC No. 154.

Cancellation of debt by merchandise creditors not gratuitous. Creditors of taxpayer, a coal and oil dealer, agreed to accept payment of $26,000 in full settlement of their accounts in the amount of $96,000. After the debt cancellation, taxpayer was solvent in the amount of $28,000. The court holds the creditors obtained the best settlement possible; there was no intent to make a gift. Ordinary income was therefore realized to the extent of the debtor's solvency after the cancellation. The tax-benefit rule is held not applicable because of the absence of any relationship between the cancellation and losses incurred in the purchase and sale of coal and oil in a prior year. *Capitol Coal Corp.,* 26 TC No. 148.

Prisoner of war payments excluded from gross income. Under the War Claims Act Amendments of 1954, the U. S. Government paid those who became prisoners of war during the Korean conflict. Since this pay is compensation for damages, it is not includible in gross income. *Rev. Rul.* 56-462.

Withholdings for state retirement plan taxable. Amounts deducted from the

compensation of employees of the State of Arizona and credited to their retirement accounts constitute taxable gross income in the year deducted. *Rev. Rul.* 56-473.

Casino dealer's "side money" is compensation. Amounts received by a dealer in a gambling casino as the result of wagers made in his behalf by the patrons are not gifts but constitute taxable compensation. *Bevers,* 26 TC No. 153.

OPERATING LOSSES

Corporate loss allowed individual as operating loss; he contracted to assume it. Taxpayer contracted with a corporation to carry on its operations and business. In return, he was to receive all of the profits and absorb all of the losses. The court holds taxpayer was in the "business" of performing the services under the contract. A corporate loss of $87,000 which taxpayer was required to make good was therefore deductible by him as a business loss and was available as a net operating loss carryback. *Ripley,* 26 TC No. 150.

No annualization of short period net loss. A net loss sustained during a short taxable period occasioned by a change of accounting period may not be annualized for carryback or carryover purposes. The Code does not permit annualization for this purpose. [For the purpose of computing tax, income for such a short period is annualized.] *Rev. Rul.* 56-463.

Loss carryover from 1944 must be applied to 1945 loss year before 1946. In 1944, taxpayer sustained a net loss which he carried over to 1946 as a net operating loss deduction. He contended that since he sustained a net loss for 1945, no adjustments to the carryover were required for any Section 122(d) items used in computing the 1945 loss. The court disagrees; it holds that since the net "loss" for 1945 after Section 122(d) adjustments resulted in an income which exceeded the net operating loss carryover from 1944, there was nothing available for carryover to 1946. *Rubin,* 26 TC No. 139.

OTHER DECISIONS

Advances to bankrupt corporation are nonbusiness bad debt. Advances of some $10,000 by one in the check-cashing business to a corporation manufacturing furniture are held to be loans which became worthless when the corporation went into bankruptcy. As taxpayer was not in the money-lending business and the loans were not proximately related to his check-cashing activities, the loans were to be treated as a nonbusiness bad debt. *Feingold,* TCM 1956-214.

Corporation cannot deny existence as separate entity. Taxpayer contended that although it was a corporation in form, in truth and fact it was the alter ego of one Jordan, its 98% stockholder, and was therefore not liable for any corporate income tax. The Tax Court holds otherwise. Taxpayer always operated as a corporation; it was formally incorporated, stock was issued, bylaws were adopted, directors were elected, minutes were kept, corporate records were maintained, and corporation income tax returns were filed. However, the court holds that although taxpayer was a personal holding company, no liability for the personal holding company surtax exists because the corporate income was distributed to Jordan as it was received and such distributions qualified for the dividends paid credit. *Sebago Lumber Co.,* 26 TC No. 137.

Crop shares income when reduced to cash. Whether the cash or accrual basis is used, crop shares received as rent are to be reported as rental income only when they are reduced to cash or its equivalent. A farmer who uses the crop share received as feed for livestock is not considered as having reduced his share to money or its equivalent. Therefore, the receipt does not affect either the retirement-income credit or self-employment income. *Rev. Rul.* 56-496.

Market value basis for property acquired at foreclosure. A warehouse had been sold at a foreclosure sale for $350,000 to a bondholders committee which held $535,000 of the $550,000 in defaulted bonds issued by the owner. The bondholders transferred the property to taxpayer in a tax-free exchange. As the bondholders could have bid in the property at any amount up to the full face value of the bonds plus interest, the basis of the warehouse for depreciation is held to be its fair market value at foreclosure which was determined at $450,000. Furthermore, in computing taxpayer's invested capital for its excess profits tax, the $450,000 value was to be allocated between the bonds and stock issued in exchange for the property. *Merchants Warehouse Co.,* TCM 1956-221.

Abandonment "identifiable event" for worthlessness. Taxpayer owned royalty interests on lands in which oil companies had purchased oil leases for mineral development. The failure of the oil companies in 1949 to pay rentals to keep in effect their leases was held to amount to an abandonment of the property for oil development. Accordingly, taxpayer's royalty interests became worthless in the same year. *Lack,* TCM 1956-222.

Cash-basis taxpayer doesn't realize cash on "receipt and option" sale until cash is received. [*Non-acquiescence*] A decedent who had been reporting on the cash basis sold some farm property in 1947 under a "receipt and option." The court treats the transaction as a sale, though some Colorado courts regard such documents as mere options. The document called for a down-payment and annual installments over succeeding years until the full purchase price with interest was paid. The contractual obligations were held not amounts realized in 1947. The Code defines amount realized on a sale as cash plus fair market value of other property. However, the "receipt and option" is in no sense a note, mortgage, or other obligation of the buyer such as would be income, even though the taxpayer is on a cash basis. It is a mere schedule of payments, in effect an account receivable. It has no value. Since the payments were not in excess of his basis for the property sold, he realized no gain on the sale in 1947. *Hurlburt Estate,* 25 TC No. 152, *non-acq.,* IRB 1956-37.

No deductible loss on Eisler's forfeiture of bail; recovery possible. In 1947, taxpayer deposited $20,000 as bail for Gerhart Eisler which was forfeited in 1949 when Eisler fled from the country. However, taxpayer did not sustain a loss in 1949 because at that time it had outstanding indemnity agreements from various persons for the repayment of the funds. It was not clear in 1949 (nor was it clear at the time of decision) that the indemnity agreements are worthless. The court also holds that funds obtained by taxpayer were not income; they were contributions or gifts. *Bail Fund of the Civil Rights Congress,* 26 TC No. 57.

TAX CONSEQUENCES OF

Corporate organization and distributions

EDITED BY RICHARD L. GREENE, LL.B.

What to do about the new intent test in thin incorporations; more on Gooding

by **ROBERT W. MANLY**

Last month we considered here the approach the Tax Court is taking on thin-incorporation cases. Now Mr. Manly gives us a thoughtful analysis of the cases following Gooding. He provides us with some extremely-valuable suggestions the stockholder-debtor can use to forestall tax trouble

IN *Gooding Amusement Co.*,[1] the Tax Court took a new approach to the oft-litigated problem of the status of debts of a close corporation to its controlling stockholders. It found that the persons holding both the stock and the notes were essentially interested in the corporation as stockholders and that they never intended to enforce their rights as creditors to the detriment of their interests as stockholders. These findings were based upon the testimony of Mr. Gooding, the corroborated inferences drawn from the position of the ordinary stockholder owning a pro-rata share of the debt, and the presumption of the correctness of the Commissioner's determination. Contrary to the arguments of the taxpayer, it was found that there was no substantial business purpose for the issuance of notes rather than additional stock and that the notes were shams which were used to avoid tax. That the corporation was adequately capitalized by normal standards (about a one-to-one ratio) was held to be not decisive of the issue. The result approaches a rule that such stockholders may not be creditors.

Issuing a considerable portion of debt securities to stockholders upon the formation of a corporation has provided many tax advantages. Stockholders could withdraw the earnings of a successful business in the form of tax-free repayments of the principal of their loans; a corporation could pay a return to the stockholders on a portion of their investment in the form of deductible interest and, in some cases, stockholders were able to deduct a business bad debt instead of a capital loss on worthless stock if the business failed. These tax advantages constituted one of the most widely known and supposedly sound "loopholes" in the tax structure.

Prior to the *Gooding* decision, in cases involving no ambiguity in the instruments of the indebtedness held substantially pro rata by the stockholders, the courts generally denied the existence of a debtor-creditor relationship only if the ratio of debt-to-equity capital was greater than four to one. That showed the corporation to be inadequately capitalized. The Commissioner has acquiesced in *Ruspyn Corporation*[2] where a debt-to-equity ratio of three and one-half to one was held to establish the debentures in question as bona fide indebtedness.

The Gooding facts

Gooding, his wife and daughter owned a partnership business which they transferred to a newly-organized corporation for all of its stock and certain five-year serial notes. There was a gain on the transfer on which a capital gains tax was paid. Subsequently the corporation paid a portion of its notes but defaulted in payment of the remainder. At this time, it was borrowing substantial amounts from banks. These loans were promptly repaid. This subordination of the stockholders' notes was declared "too marked to permit us to find that a bona fide debtor-creditor relationship was established."[4]

The key to the Tax Court's approach to the problem is found in its statement, which was quoted with apparent approval by the Court of Appeals:

"The most significant aspect of the instant case, in our view, is the complete identity of interest between and among the three noteholders, coupled with their control of the corporation. . . . It is, in our opinion, unreasonable to ascribe to the husband petitioner, F. E. Gooding, an intention at the time of the issuance of the notes ever to enforce payment of his notes, especially if to do so would either impair the credit rating of the corporation, *cause it to borrow from other sources the funds necessary to meet the payments*, or bring about its dissolution." (Italics supplied.)

Upon this basis, the Tax Court held that the payments of the notes were essentially equivalent to taxable dividends paid to stockholders. The court denied the interest deduction claimed by the corporation. It also held that the property ostensibly acquired by the corporation for notes was actually acquired for stock in a transaction under Section 112(b)(5) of the Code, and that the basis of such property was not increased by the gain which had been erroneously recognized and taxed to the stockholders. This ruling, of course, reduced the corporation's allowable depreciation deduction.

Subsequent cases

The Tax Court filed the *Gooding* opinion on November 30, 1954. Since then, most of the decisions have relied on the old ratio test to determine status of corporate debt held by stockholders, although they repeatedly stated that the intention of the parties is determinative. However, it should be observed that these cases, almost without exception, involved debt ratios in excess of the key ratio of three and one-half to one approved by the *Ruspyn Corporation* case and undoubtedly were tried by the Commissioner upon that theory.

One of these recent cases, *Estate of Herbert B. Miller*,[5] involved a debt ratio of some 175,000 to 1, but the Tax Court

did not base its decision that the notes in question were in fact risk capital upon the thin-incorporation test. Rather, it followed the lead of its *Gooding* decision by inferring that the stockholders had no intention to act as creditors in the absence of business purpose for the debt structure of the corporation. That the notes in question were secured and were not expressly subordinated to obligations to other creditors was stated to be not impressive. The Tax Court found that the partners who incorporated the partnership business intended that all the assets "should remain indefinitely at the risk of the going business as part of its permanent capital structure." The Tax Court continued: "To be sure the partners undoubtedly expected . . . earnings to be sufficiently high that in a relatively short time they would be able to withdraw sums . . . without impairing necessary capital; and subsequent events seem to prove this expectation to have been justified. . . . Only surplus earnings, to be subsequently acquired as the result of successful operation of the business, were in fact intended to be withdrawn. . . . It demonstrates plainly to us that the partners intended to use the notes as a device to siphon subsequent earnings from the enterprise while leaving the basic business assets with the corporation." The court added: "In the light of all of the surrounding facts and circumstances, it is not reasonable to accept the absoluteness in form of the notes at face value. To do so would impute a willingness on the part of the partners to endanger their chief source of livelihood."

On August 17, 1956 the Tax Court again applied the new approach to these questions in a memorandum decision, *Ryan Contracting Corporation*. Closely following its decision in the *Gooding* case, it based its opinion on the lack of evident intention on the part of the stockholder-creditors to demand repayment of the amounts advanced and the admitted fact that it would have been impossible to operate the corporate business as it was without the funds in question. It is significant that the Tax Court expressly stated that it did not decide whether or not the corporation was a thin corporation "because whether it was or not is only one of many facts to be considered. . . ." The presence or absence of any non-tax business purpose for the issuance of the notes was not discussed.

How to plan in future

In planning the organization of new corporations, it is suggested that the tax-saving objectives of a thin incorporation can often be achieved by loans from outsiders, possibly even if guaranteed by stockholders. Existing corporations caught in the *Gooding* trap may be able to extricate themselves and their stockholders by refinancing their debt with outsiders. In theory, such present action will not overcome an existing intention at the time of the original issuance of the indebtedness, but payment out of borrowed funds will be evidence of an intention to act as a creditor as indicated by the italicized portion of the *Gooding* opinion which is quoted above.

It appears that the stockholder-creditors may solve their problems if they can arrange for an unconditional sale of the debt to an unrelated third person. Such sales usually will be possible at the time the due date or call date of the indebtedness is at hand. Assuming that the sale was not a sham, there would be no distribution by the corporation to a stockholder which could give rise to dividend consequences. Only capital gain or loss would result. In any event, no default or subordination of the debt held by stockholders should be permitted.

Although we should not delude ourselves by wishful thinking, there is hope that, even if the *Miller* case is not overruled on the appeal which is pending, application of the *Gooding* and *Miller* cases will be at least substantially limited. The dissent to the majority opinion on the appeal of the *Gooding* case may convince a majority in future appeals. The dissent stated that the notes were, in substance as well as form, legally enforceable obligations which at all times were represented as such, and that there was no evidence from which reasonable inference could be drawn that the parties did not intend that the notes should create a bona fide indebtedness.[6]

The requirement that a creditor must intend to exercise all of his rights as such, even to his own detriment, appears to be an extreme position taken to prevent tax avoidance. Bona fide creditors often consent to the subordination of claims and to extensions of maturities. Corporations and their stockholders should be entitled to issue whatever classes of securities and in whatever proportions they may choose, within reason, regardless of tax consequences. The fact that it is intended to pay off debt out of earnings does not appear to warrant the taxation of payments of principal as dividends. It is rare that a corporation does not intend to pay its debts out of income except in the case of seasonal borrowings.

The *Gooding* and *Ryan* cases dealt with corporations owned by one family. The *Miller* case involved a three-man partnership which was incorporated with grossly-inadequate capital and probably could have been decided on that ground alone. The application of

[*Robert W. Manly is an attorney and certified public accountant. A graduate of the Harvard Law and Business Schools, he is associated with the Chicago law firm of Miller, Gorham, Wescott and Adams.*]

[1] 23 TC 408, *aff'd*, 6th Cir. (8/1/56).
[2] 18 TC 769.
[3] 326 U.S. 521.
[4] See, however, John W. Walter, Inc., 23 TC 550, *acq.*, where the subordination of notes held by a sole stockholder was ruled to be not significant.
[5] 24 TC 923, on appeal to the Ninth Circuit.
[6] See Kraft Foods Co., CA-2, 4/24/56 [5 JTAX 37].

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the *Gooding* case might well be limited to family-owned corporations or at least to those in which the number of shareholders is relatively small. The validity of the inference that stockholder-creditors do not intend to enforce their creditor rights tends to break down if the stock of the corporation is not held by one man or a group dominated by one man and if minor, scattered interests are involved.

The general application of the *Gooding* principles would represent a major change in the understanding of basic concepts of tax law. It is submitted that such changes should be made by statute rather than the courts. Whether the change is accomplished by statute or by the courts, it would certainly not be equitable to apply it retroactively in view of the Commissioner's acquiescence in the ratio of debt test. ☆

Four important new rulings under Subchapter C show IRS sympathetic, sound

SEPTEMBER 10, 1956, was a prolific day for the Commissioner in the field of Subchapter C. On that day he announced four rulings, each on a significant question affecting a liquidation, a redemption, a spin-off and a split-off. In each ruling the Commissioner applied a sensible and sympathetic approach to the taxpayer's problem.

Net operating losses and Section 337

Rev. Rul. 56-448 (IRB 1956-37, 11) solves favorably the troublesome problem of whether a corporation having unrealized gain in a Section 337 liquidation will thereby lose all or part of the operating loss carry-back. Frequently a liquidation is induced by a substantial operating loss, but in the process of winding up and selling assets, the corporation may have considerable gain from such sales. Thus, Jones Corporation has an operating loss in 1956 of $200,000 and unrealized gain of $250,000 from the sale of assets under Section 337. If the gains (which are, of course, not taxed to the corporation under Section 337) could be used to offset the operating loss, the result might be discouraging enough tot dissuade the management from carrying out a properly timed liquidation.

Fortunately, Internal Revenue has properly construed the provisions of the operating loss section (Section 172 of the 1954 Code and Section 122 of the 1939 Code) so that the unrecognized gain under Section 337 will not require any adjustment to the carry-back. Hence, the operating loss deduction in the earlier year is not to be reduced by the Section 337 gain.

This ruling may also serve as a reminder that the "quickie carry-back" claim for refund for the earlier year is an asset to be distributed to the shareholders. Moreover, this asset should be taken into account in determining the amount of taxable gain to the stockholders from the liquidation.

Split-off of subsidiary approved

Rev. Rul. 56-450 (IRB 1956-37, 15) demonstrates the feasibility of splitting off a subsidiary from its parent. It also points up the basic requirements of Section 355 as construed by Internal Revenue: (1) a valid business purpose for the transaction; (2) each of the two businesses must have been actively conducted for at least five years before the distribution; and (3) after the distribution both corporations will continue to be active. The ruling also noted that no sales of stock are contemplated to be made after the distribution. This, of course, is an echo of Internal Revenue's "bail-out" concept. All of these requirements were met and, hence, the ruling was favorable.

The interesting feature of *Rev. Rul.* 56-450 is that it approved not only a split-off of the two businesses but also of the shareholders. After the transaction was over, we find that three shareholders who had previously owned only 15% of the stock of the parent, ended up owning over 80% of the stock of the former sub. This shifting of proprietary interest among stockholders, which is now permitted under the 1954 Code, may, however, create problems if in the exchange there is a disparity in the value of the stock surrendered and the stock received. The value of closely held stock is always difficult to determine and, where the stockholders are closely related, there may be a gift effected by the disparity or there may be an element of compensation. These possibilities are recognized in several cross referenced provisions in Subchapter C.

The Service neatly ducked this problem by observing that no opinion is stated as to whether the split-up may result in gifts or in the payment of compensation to any stockholders. While this reservation may be sound from an administrative standpoint, to the taxpayer involved it may be thought of as an unwelcome cloud whose contents may someday descend.

Section 303 redemption

Some fiduciaries and tax men had been puzzled and uncertain whether a Section 303 redemption could be used to pay funeral and administration expenses paid before the enactment of the 1954 Code. Their doubts were founded on the fact that the old Section 115(g)(3) of the 1939 Code covered redemptions only to pay death taxes, but not funeral and administration expenses. Section 303 of the 1954 Code was liberalized to include the cost of funeral and administration, but that Section did not itself specify whether such expenses had to be paid after the enactment of the 1954 Code.

Rev. Rul. 56-449 (IRB 1956-37, 13) has now set that problem, and a related worry, to rest. It is now definite and clear that a redemption under Section 303 covers funeral and administrative expenses incurred and paid prior to the enactment of the 1954 Code. It likewise covers those administration expenses whether they were deducted on the estate's federal income tax return or on its estate tax return. Thus, fiduciaries and tax men concerned with estates pending for over two years may proceed with certainty on their delayed redemptions.

Spin-offs revisited

In our earlier issues we expressed enthusiasm that Internal Revenue had finally approved a spin-off. Now we are delighted to note another spin-off has succeeded the statutory hurdles of Section 355 and the confirming policies of the Internal Revenue Service. Hence, our title "spin-offs revisited", which is borrowed from a talk by Lester Ponder, one of our regular contributors, who brought to life an audience which had previously heard him discuss spin-offs under the 1939 Code.

Rev. Rul. 56-451 (IRB 1956-37, 17) announces no startling principles, but

it does demonstrate that approval of the Service is possible if ample business reasons are supplied. The outstanding feature of the ruling is that it is feasible to spin-off a separate component of an entire business.

Such a separation is not always easy to accomplish. Here the corporation published four trade magazines. One was directed to one industry and the others to another distinct industry. The editorial staff and advertising salesmen were separate. So were the offices, although in the same building. Separate accounts were kept on the books for each publication. The only common employees were general officers and certain clerical and production employees. The readers and advertisers of the publications were distinct and their respective problems were also different.

Thus, a clear showing of "separateness" was established in this particular ruling. Frequently a corporate taxpayer is not able to furnish satisfactory proof that it has been operating two separate and distinct businesses. Since this is a major condition of Section 355, good practical long-range planning would suggest the desirability of establishing early in the corporate life the maximum degree of this metaphysical separation—if a spin-off is ever to be one of the ultimate goals or possibilities. Even if no spin-off were ever contemplated, it is good business to keep departments separated on the books so as to maintain closer control over costs and sales.

New corporate decisions this month

Loans by sole stockholder really capital contributions. Taxpayer-lawyer made advances to a wholly-owned corporation which was formed to operate an ice arena. The Tax Court holds these advances were capital contributions rather than loans. No date was set for repayment, no interest was paid, no security was given, and he was in nowise given preference over the general corporate creditors. On liquidation of the corporation, the unpaid portion of such contributions was therefore a capital, rather than an ordinary loss. *Dorsey,* TCM 1956-212.

Pro-rata redemption of part of preferred not a dividend. The Service holds that a pro-rata redemption by a corporation of 20% of its preferred stock is not essentially equivalent to a dividend where no single shareholder or family group had more than 25% of the voting power. Shareholders who held both preferred and common generally did not hold preferred and common in the same proportion as the common. *Rev. Rul.* 56-485.

Pro-rata redemption of preferred equivalent to a dividend (old law). Payments received in 1950 and 1951 by the stockholders of a successful and expanding manufacturing company in pro-rata redemption of their preferred stock are held to be essentially equivalent to the distribution of a taxable dividend. There was no change in the stockholders' proportional interest in the common shares, no corporate-business purpose, and no contraction of corporate invested capital. The Tax Court finds the net effect of the redemption is the same as if a cash dividend had been paid. *Kessner,* 26 TC No. 134.

Substantially all assets transferred in reorganization; it is tax-free. [*Acquiescence*] Taxpayer had a wholly-owned company which in turn owned 50% of another. The parent and subsidiary were combined into one by creating a new corporation all of whose stock was issued for all the assets of the two old companies except the parent's shares in the subsidiary. The Commissioner argued that because of this exception the parent did not transfer substantially all its assets. The Tax Court held it did, because all the assets of the subsidiary, including therefore the parent's equity, were transferred. *George,* 26 TC No. 49, *acq.* IRB 1956-39.

102 penalty rejected; war earnings accumulated for future expansion (old law). As a manufacturer of woodworking machinery, taxpayer had accumulated a very substantial undistributed surplus during World War II. The Court holds it was not subject to the Section 102 penalty; the accumulated earnings, taxpayer showed, were needed for postwar expansion and improvement of plant which was obsolete and unfitted for intense postwar competition. *Newman Machine Co.,* 26 TC No. 133.

1h

Income from operation of farms is not "rent." [*Non-acquiescence*] Rents are included in personal holding company income unless they constitute 50% or more of corporate gross income. A corporation owning farms contracted with farmers to farm the property. They paid a stated percentage of crops as compensation. The corporation kept detailed records of the operations and exercised active management and supervision through an agent. The Tax Court held that the income derived from the farm operations was not rent; it was income from farm operations. *Webster Corp.,* 25 TC No. 10, *non-acq.* IRB 1956-39.

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No gain on redemption of stock to cancel debt; value equaled basis. [*Acquiescence*] Taxpayer surrendered her stock to a corporation in satisfaction of a debt she owed it. The Tax Court held she realized no gain on the transaction; the indebtedness was satisfied at full value by the surrender of the stock at $100 a share, which was also its fair market value and basis to the taxpayer. *Waldheim,* 25 TC No. 96, *acq.* IRB 1956-39.

$42,000 salary reasonable—officer not in control. A $42,000 salary to a corporate officer is held to be reasonable because the board of directors had approved it in advance and taxpayer and his sons owned 40% of the stock of the corporation but did not control the board. A $6,000 expense allowance seems reasonable to the court. The total entertainment account including this sum amounted to only 1/10 of 1% of sales. However, because the expense was not substantiated, this $6,000 is held to be additional compensation. The total of the salary and the allowance is reason-

tax problems?

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able as a salary deduction. *Williams Co.*, DC La., 7/11/56.

Distribution of current earnings in liquidation not a dividend for holding company surtax. Taxpayer was a personal holding company prior to its total dissolution on June 14, 1948. Throughout the year, taxpayer had a deficit in its accumulated earnings and profits, but it did have current earnings and profits. Taxpayer contended that the current earnings and profits distributed in dissolution were dividends for the purpose of computing the paid credit personal holding company surtax. The district court agreed, saying that by complete liquidation it got current earnings into the hands of its stockholders and satisfied the intent of Congress in imposing a surtax on undistributed earnings. The district court noted that the Commissioner had changed his position on this issue in 1954. An IT, issued in 1937 and in effect while the taxpayer liquidated, supported taxpayer's argument. This court reverses. Only dividends are available for credit, and the Code clearly distinguishes between a dividend and a distribution in liquidation. *St. Louis Co.*, CA-3, 9/24/56.

No dividend on redemption of preferred exchanged for salary notes. From 1942 to 1945, taxpayer received notes from his corporate employer in settlement of his salary and reported their full face value as taxable income. Later, several of the notes were exchanged for preferred stock to improve the corporation's credit position. The Tax Court holds that redemption of the preferred was not a taxable dividend; it was merely the completion of the initial transaction of repaying the notes and making a cash salary payment for which the notes had originally been issued. *Golwynne Estate*, 26 TC No. 151.

RECENT DECISIONS AFFECTING EXEMPT INSTITUTIONS

Foundation's investments and accumulation of income reasonable. In a long opinion reviewing the cases and legislative history leading to the restrictions on charitable foundations embodied in the Revenue Act of 1950, this court, in one of the first cases arising under that act, upholds the exemptions of this foundation. The Commissioner had claimed that because of its investment activity the foundation was not operated exclusively for charity and that it unreasonably accumulated income. Concerning the investment policy, the court concedes that it was not typical of charities because many of the investments were in second and third mortgages and the foundation had borrowed about a million dollars to buy stock of Food Fair (publicly held but operated by the founder) even though a three-point decline in the stock would have wiped out the whole foundation. Nevertheless, the court holds that the investment activity did not amount to a business and did not cloak tax avoidance. Concerning the unreasonable accumulation, the court notes that the foundation pledged $500,000 to Brandeis University for a medical research building. To accumulate this sum would take six or seven years at current rates of income and receipts of donations. This is a reasonable program. *Friedland Foundation*, DC NJ 8/24/56.

No exemption for veterans post, with social members; or for corporation holding building. Affirming the Tax Court, the Third Circuit denies exemption from taxation to a post of Polish Army veterans. The parent association had been ruled exempt, but this post took in "social" members who paid dues, were admitted to the clubhouse, but were ineligible for disability benefits. The post therefore could not qualify either as a fraternal beneficiary society (benefits were not payable to all members), as a nonprofit club (earnings from the bar inured to the veteran members as benefits), or as a civic league (for the same reason). The association which was formed to hold the post building and attached real property was operated for profit; it used the rents to pay off the mortgage. The case is remanded to the Tax Court for determination of deficiencies and penalties, if any. *Polish Army Veterans Post*, CA-3, 9/17/56.

Tax-exempt status denied. An individual operated a masonry business through three entities: partnership, corporation and foundation, all taxpayers here. The foundation was set up to aid needy students, and certain contracts were taken in the foundation name. After noting these facts, the court merely states that taxpayer's foundation failed to sustain the burden of proof that the foundation was organized and operated exclusively for charitable or educational purposes. The court gives no reasoning. The foundation is denied tax-exempt status, and contributions to it are not deductible. *Lichter Foundation*, DC Ohio, 7/17/56.

University alumni association tax exempt. An alumni association organized primarily to promote the welfare of the university with which it is affiliated, subject to its control, and operated as an integral part of it, qualifies as a tax-exempt educational organization. *Rev. Rul.* 56-486.

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ROBERT M. MUSSELMAN, LL.B.; C.P.A.
(Lecturer in Federal Taxation, University of Virginia, Departmental editor of the Journal of Taxation.)

CONTRIBUTORS

Richard H. Barrick, LL.B.
Carolyn Clarke, LL.B.; C.P.A.
A. Gordon Colley, Jr., LL.B.; C.P.A.
Wallace M. Davies, LL.B.
Kenneth E. Fox, LL.B.
Daniel S. Knight
William J. Linkous, Jr., LL.B.
Charles M. Lobban, LL.B.

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